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THE (D) REORGANIZATION — POSSIBILITIES AND PITFALLS

by

*Malcolm L. Shaw**

I. JUDICIAL HISTORY

1. Generally
2. "Business Purpose" Interpretation
3. Continuity of Interest—Before and After

II. REQUIREMENTS OF A (D) REORGANIZATION

A. Control After the Transfer

1. Percentages
2. Options, Warrants, and Subscriptions
3. Intention To Control
4. The Binding Commitment
5. Momentary Control
6. Creditors
7. Third-Party Control
8. Creeping Control
9. Attribution
10. The Government's Position

B. Plan of Reorganization

1. Form of Plan
2. Intent
3. Contents
4. The "Steps"
5. Amendment
6. "In Pursuance of"
7. Time
8. Third Parties

C. Parties to a Reorganization

D. "Substantially All"—Section 354(b)(1)(A)

III. COMPARISONS WITH OTHER REORGANIZATION TYPES

1. The (A) Reorganization
2. The (B) Reorganization
3. The (C) Reorganization
4. The (E) Reorganization
5. The (F) Reorganization

IV. LIQUIDATION-REINCORPORATION

V. INTERACTION OF THE (D) WITH OTHER CODE SECTIONS

1. Section 337
2. Section 355
 - (a) The Code Requirements
 - (b) The Rulings
 - (1) Old or New Trade or Business

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(2) Rental Property

3. Section 351
4. Section 381
5. Section 356
6. Section 1551
7. Section 312
 - (a) Generally
 - (b) Deficits
 - (c) Section 354 Qualifications
8. Section 306
9. Basis
 - (a) To the Shareholder
 - (b) To the Transferor

VI. CONCLUSION

THE (D) reorganization takes its popular name from the subparagraph designation in section 368(a)(1)(D) of the Internal Revenue Code of 1954. The six subparagraphs of section 368(a)(1) are divided into two general categories. (A) through (C) are known as amalgamating reorganizations, combining at least two corporations. (D) through (F) are generally referred to as divisive reorganizations, in that a corporation is split into or divided among two or more corporations, either new or existing. Although the definition of each type of reorganization appears to be well settled by case law, Rulings, and Code sections, considerable overlap and duplication still exist.

The (D) reorganization by definition must qualify under section 354, 355, or 356. Each of these sections in turn calls other Code sections into play. For example, control as defined in section 368(c) plays a major role in the disqualification of (D) reorganizations, yet no formal Code reference is made to this subsection.

The (D) reorganization may be acquisitive as well as divisive. If the (D) is qualified under section 354(b)(1)(A), an acquisition similar to an (A) reorganization is effected. But it is not the transferor corporation that acquires; the transferee corporation must take "substantially all" the assets of the transferor. Absent qualification under section 354, the (D) must meet the rigorous tests of section 355. This section presupposes the existence of numerous complicated conditions which few corporations can meet. Section 356 is simply the "boot" section for sections 354 and 355. It permissively allows extra consideration to pass in qualified exchanges in which something other than stock or securities pass. Section 356 per se is not a qualifying section for the (D) reorganization.

The purpose of this Article is to present the pattern, incongruous at times, of qualification and disqualification of (D) reorganizations. An explanation of, or comparison with, analogous areas will be offered in order that the reader may draw his own conclusions.

In all likelihood the (D) reorganization has not seen full growth in the present state of case law or Ruling interpretation. Historically, inconsistent

resolution of similar facts by different tribunals has had the effect of reaching a decisive solution without protracted delay. It is hoped that this Article may speed the (D) reorganization to its ultimate destination.

The reasons for having a corporate reorganization are varied, as is the selection of the type to be employed. The importance of section 368 is that it allows corporations to reorganize under one, or even in some instances a combination, of the subparagraph types without recognition of tax to either the shareholder or corporation. Only the form in which the business is conducted is changed. This is not deemed by Congress to be a significant event for the recognition of tax. As such, the bases of the assets and shares of stock usually remain unchanged in the exchange.

The (D) reorganization has undergone a number of changes over the years. The Revenue Act of 1918 first introduced the concept of a tax-free reorganization.¹ While the (A), (B), (C), and (F) reorganizations became a part of the Code in 1921,² it was not until the Revenue Act of 1924,³ that the (D), although not then so titled, was born. Changes in both content and enumeration persisted until the (D) was finalized in the 1954 Code as:

Sec. 368. Definitions Relating to Corporate Reorganizations.

(a) Reorganization—

(1) *In General.*—for purposes of parts I and II and this part, the term 'reorganization' means—

....

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356⁴

The (D) reorganization moves in the Code as the knight in chess. As the other reorganization types amalgamate and combine, the (D) divaricates in dividing corporations. It becomes compatible again by qualification under section 354, where it resembles the theme of all other reorganizations. The (D) is used by both the taxpayer and Commissioner in an attempt to achieve a result not necessarily favored by the other, a nuance not present in the other reorganizations.

Though divisive, it may also be acquisitive, in the sense that a control of an almost limitless number of corporations may be obtained by the transferor's shareholders. By definition the (D) requires a qualifying distribution and obtention of control of the transferee. If for some reason the (D) is not completed by the qualifying distribution, but the requisite control is present, still no tax results because section 351 has been met.⁵

¹ Act of Feb. 24, 1919, ch. 18, 40 Stat. 1057.

² Act of Nov. 23, 1921, ch. 136, 42 Stat. 227.

³ Act of June 3, 1924, ch. 234, 43 Stat. 253. The (D) was then enumerated (B).

⁴ INT. REV. CODE of 1954, § 368(a)(1)(D) [hereinafter in textual material the current Code will be referred to by section number only].

⁵ See notes 245-57 *infra*, and accompanying text.

Through the development of case law and rulings the (D) has evolved into an area of some mathematical exactitude, in that the objective standards are fairly ascertainable. Nevertheless, there are present all the nebulae of engrafted principles emanating from the application of the subjective standards of law common to all tax transactions which help to cloak the provision in mystery.

The following reflects the development of the (D) reorganization. Often the objective standards of qualification are met, yet subjective standards are lacking. The criteria, objectives, and sanctioned and prohibited usages will be discussed. However, no claim is made that a consistent treatment has ensued with the interpretation of the (D) reorganization requirements. In areas in which inconsistencies abound, an aspirant guess will be made in an effort to resolve the resultant dilemmas.

I. JUDICIAL HISTORY

1. *Generally.* Before the 1954 Code the (D) reorganization did not require a distribution of the securities received.⁶ By judicial interpretation a transfer could be made in a liquidation through the shareholders to the transferee corporation or from the transferor to the transferee. While the taxpayer had used the (D) as a shield from taxation on the theory that no economic gain is actually realized on the transaction,⁷ the Commissioner used it as a sword to attack liquidation-reincorporation cases.⁸

The amendment to subparagraph (D) in 1954 was intended to cause taxation in the (D) situation unless there was a transfer of substantially all of the assets as a qualification to the reorganization.⁹ Otherwise, it was believed, such a situation involved true economic gain. While Congress intended to help the Commissioner combat the reincorporation problem,¹⁰ instead it obstructed his efforts. The amendments made it easier for the taxpayer to transfer assets to a new corporation because of the protection of qualification under section 354.

In 1954 the House of Representatives attempted to deal with the problem in H.R. 8300.¹¹ This bill provided that (1) if tax avoidance was the principal purpose of the transaction, (2) the transferee is formed within five years of liquidation of the transferor, and (3) fifty percent of the transferee's assets were transferred to the transferor with continuity of at least fifty percent of the stock in the former shareholders, taxation of the retained assets as a divi-

⁶ For example § 112(g)(1)(C) of the 1934 Revenue Act read: "[A] transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred." Act of May 10, 1934, ch. 277, § 112(g)(1)(C), 48 Stat. 680.

⁷ See R. PAUL, *STUDIES IN FEDERAL TAXATION* 152 (3d series 1940).

⁸ Discussed in section IV *infra*.

⁹ As required by INT. REV. CODE of 1954, § 354(b)(1)(A).

¹⁰ To play the liquidation-reincorporation game, the taxpayer liquidates the old corporation under § 331, siphons off the non-essential liquid assets, reports all gains at capital gain rates, and puts the balance of the assets back into a new corporation. The Commissioner asserts that in essence a (D) reorganization took place. The assets retained are distributions to which § 356 applies, resulting in dividend treatment.

¹¹ H.R. 8300, 83d Cong., 2d Sess. (1954).

dend would result to the shareholders. Unfortunately for the sake of clarity in this area, the Senate rejected the House bill, commenting that the possibility of tax avoidance was not sufficiently serious at that time to require a special statutory provision.¹² Apparently the thinking was that the problem could be treated within the existing framework of the law. Except for judicial gloss on the affirmative usage of the (D) reorganization, the Commissioner lacks reincorporation weapons.¹³

2. "*Business Purpose*" Interpretation. It was a (D) reorganization that spawned the famous¹⁴ business purpose doctrine of *Gregory v. Helvering*.¹⁵ Mrs. Gregory owned all the stock of United Mortgage Corporation, which in turn owned 1,000 shares of Monitor Securities Corporation. Her desire was to obtain the latter stock, but if United sold it, and distributed the funds to her, the distribution would be a dividend. Averill Corporation was formed, to which United spun off Monitor. Mrs. Gregory liquidated Averill, sold Monitor, and reported capital gains. The Supreme Court said that there was no business purpose involved and that the transaction was nothing but a tax avoidance scheme. Even though the literal requirements of a reorganization had been followed, no business purpose was present; thus, dividend treatment became applicable.

Anticipating the problem of what seemed to be large amounts of revenues escaping taxation via the spin-off route, Congress withdrew nonrecognition of gain in spin-off distributions in the Revenue Act of 1934,¹⁶ even before the *Gregory* decision was handed down by the Supreme Court. But spin-offs came back into the fold when section 317(a) of the Revenue Act of 1951 amended the 1939 Code by adding section 112(b)(11),¹⁷ extending nonrecognition of gain to the spin-off. Part of the *Gregory* business purpose requirement was added at that time to subparagraphs (A) and (B) under the amended section.¹⁸ The 1954 Code reiterates the tax-free treatment, provided the stock or securities received are distributed pursuant to a qualifying transaction under sections 354, 355, or 356.¹⁹

The issue may arise of whether the business purpose is that of the corporation or the shareholders. In a closely held corporation the two may become inseparable, and it may be impracticable to make the distinction.²⁰

3. *Continuity of Interest—Before and After*. Decisions under the 1939 Code placed emphasis on the shareholders' continuity of interest in the new corporation created by the reorganization transfer. If a shareholder divested himself of all stock in the old corporation for that of the new corporation, there was

¹² SENATE-HOUSE CONFERENCE COMM. REP. NO. 2543, 83d Cong., 2d Sess. 41 (1954).

¹³ This is not to overlook the standard tools of INT. REV. CODE of 1954, §§ 269, 482.

¹⁴ Or, as preferred by many, infamous.

¹⁵ 293 U.S. 465 (1935).

¹⁶ Act of May 10, 1934, ch. 277, 48 Stat. 680. Tax free treatment had previously been accorded by the Revenue Act of 1924, ch. 234, 43 Stat. 253.

¹⁷ Act of Oct. 20, 1951, ch. 521, § 112(b)(11), 65 Stat. 493.

¹⁸ *Id.* §§ 112(b)(11)(A) & (B).

¹⁹ INT. REV. CODE of 1954, § 368(a)(1)(D).

²⁰ *Lewis v. Commissioner*, 176 F.2d 646, 649-50 (1st Cir. 1949).

no continuity of interest.²¹ His interest was not counted in determining whether a substantial interest as represented by the other shareholders carried over into the new corporation. Continuity of interest under the 1939 Code did not require complete participation; seventy percent of the shareholders would suffice if they participated in the new corporation.²²

The 1954 Code virtually eliminates the continuity of interest doctrine in (D) reorganizations. The wording "one or more of its shareholders (including persons who were shareholders immediately before the transfer)," if taken literally, would not require more than one shareholder to carry the burden if he has eighty percent control. Some authorities, however, believe that old case law would still be applicable so as to impose the substantial continuity of interest requirement.²³ This pessimism is not shared by the Internal Revenue Service, however. In Revenue Ruling 57-311²⁴ one shareholder in a two-man corporation took all of the stock of a new corporation (the product of a divisive reorganization under section 355) in a (D) reorganization. Even though this represented only fifty percent continuity of interest, qualification was not at issue nor even discussed.

Under the 1939 Code (and it must be presumed to be the same under the 1954 Code) the courts would not tolerate a sham reorganization in which the main shareholders totally withdrew or only held token shares in the new corporation.²⁵ If this holds true today, the "one or more shareholders" will have to be substantial shareholders.²⁶

Continuity of interest, and for that matter the qualification of the (D) itself, is not disrupted by liquidation of the transferor after the transferee has received the assets in exchange for stock or securities.²⁷ Nevertheless, if the purpose of the reorganization is to achieve a liquidation, the necessary continuity will be lacking.²⁸

²¹ See *Morgan v. Helvering*, 117 F.2d 334 (2d Cir. 1941); *Case v. Commissioner*, 103 F.2d 283 (9th Cir. 1939); *Weicker v. Howbert*, 103 F.2d 105 (10th Cir. 1939).

²² *Reilly Oil Co. v. Commissioner*, 189 F.2d 382 (5th Cir. 1951), *aff'd* 13 T.C. 919 (1949).

²³ Cohen, Silverman, Surrey, Tarleau & Warren, *The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations*, 68 HARV. L. REV. 393, 419 (1955). The authors believe that *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933), and *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951), would be invoked in a (D) reorganization if something less than a substantial number of the old shareholders were involved.

²⁴ 1957-2 CUM. BULL. 243.

²⁵ *Weicker v. Howbert*, 23 Am. Fed. Tax R. 1256 (D. Colo. 1938), *aff'd*, 103 F.2d 105 (9th Cir. 1939). See also *Riddlesbarger v. Commissioner*, 200 F.2d 165 (7th Cir. 1952); *Hendee v. Commissioner*, 98 F.2d 934 (7th Cir. 1938).

²⁶ As a practical matter, a minor shareholder would seldom receive a significantly larger distribution in shares of a new corporation over his pro rata holdings in the old corporation. Arms-length dealers do not ordinarily possess such poor acumen as to divest themselves of their property without consideration. If the disproportion is too great, the transfer may have the overtones of a gift. See S. REP. NO. 1622, 83d Cong., 2d Sess. 274 (1954). Though all commentators cite this Report for authority on the gift theory, the author has seen no cases holding that a gift ensues.

²⁷ *Helvering v. Schoellkopf*, 100 F.2d 415, 417 (2d Cir. 1938).

²⁸ This occurred in *Glenn v. Courier-Journal Job Printing Co.*, 127 F.2d 820 (6th Cir. 1942), *aff'd* 37 F. Supp. 55 (W.D. Ky. 1941). The shareholder-taxpayer was the largest creditor of his corporation. He took a portion of the assets in liquidation to apply on the indebtedness, then put the balance of the assets in a new corporation. The appellate court ruled against a liquidation-reincorporation contention by the Government.

II. REQUIREMENTS OF A (D) REORGANIZATION

A. Control After the Transfer

"Control" is a Code requirement for all section 368(a)(1) reorganizations. It has not changed materially since the beginning of the reorganization provisions. Section 368(c) defines "control" as: "the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation."²⁹

The decisions with respect to reorganizations other than (D) are applicable, as well as control cases involving section 351, since all refer to section 368(c) as their "control" section. The definition of control under the 1939 Code is the same in the 1954 Code. Failure to meet the eighty percent control requirements of section 368(c) will cause disqualification of the reorganization *in toto*.³⁰

1. *Percentages.* Manifestly the most important percentage of control to obtain is at least eighty percent average control on voting stock and eighty percent control of each class of nonvoting stock. The percentage requirement does not mean that one hundred percent of the former shareholders must participate in the reorganization.³¹ Before the 1939 Code, 68.93 percent of the shareholders participating in the new corporation was sufficient.³² Even under the 1939 Code not all the transferee shareholders in a (D) reorganization were required to own eighty percent of the transferor's stock.³³ As an example, it would be permissible for the transferor's shareholders to own only 75.9 percent of the transferor's stock yet acquire 87.5 percent of the stock of the transferee.³⁴ The emphasis in this area is plainly after, not before the transaction.

It is also settled that the shareholders need not maintain the same relative proportionate interests after the reorganization as were maintained before.³⁵ This may certainly work to the shareholders' advantage in closely held corporations by allowing a shifting of equity ownership without the disturbance of control. In planning the capital structure of a new corporation for the purpose of effecting a reorganization, it is well to keep in mind that the authorized stock provided for in the corporate charter will not affect the control per-

²⁹ INT. REV. CODE of 1954, § 368(c).

³⁰ The definitive language of the (D) uses the word "control," which brings § 368(c) into play. See also 3 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 20.91 (rev. ed. 1965).

³¹ *Reilly Oil Co. v. Commissioner*, 189 F.2d 382 (5th Cir. 1951), *aff'd* 13 T.C. 919 (1949). See also *Miller v. Commissioner*, 84 F.2d 415 (6th Cir. 1936).

³² See note 15 *supra*, and accompanying text.

³³ *Toklan Royalty Corp. v. Jones*, 58 F. Supp. 967 (W.D. Okla. 1944), *appeal dismissed per stipulation*, 147 F.2d 856 (10th Cir. 1945).

³⁴ *Pebble Springs Distilling Co. v. Commissioner*, 231 F.2d 288 (7th Cir. 1956), *aff'd* 23 T.C. 196 (1954).

³⁵ *Roosevelt Inv. Corp.*, 45 B.T.A. 440 (1941). See also *Weicker v. Howbert*, 103 F.2d 105 (10th Cir. 1939). There is no proportionate requirement under the 1954 Code. Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, amplified by Rev. Proc. 67-13, 1967-1 CUM. BULL. 590.

centage. The control is computed on the basis of stock issued and outstanding.³⁶

2. *Options, Warrants, and Subscriptions.* Reorganizations may become the normal occasion for the issuance of certain contractual rights to the shareholders, and possibly to creditors of other third parties, for acquisition of equity ownership in a corporate party to the reorganization. Of necessity this will usually be the transferee, since it is generally a newly formed corporation with a capital structure designed primarily to effect the wishes of the transferor-controller corporation. To what extent, then, will the issuance of options, warrants, and subscriptions affect the control requirements of section 368(c)?

Warrants clearly do not count; control relates only to issued stock.³⁷ Subscription agreements are treated in the same manner.³⁸ The theory is that state law is usually determinative of the status of the stock underlying the subscription agreement. Ordinarily state law will prohibit the issuance of the stock until consideration is received for it.³⁹ Options follow the same treatment as given warrants and subscription agreements.⁴⁰

Some confusion may be generated by the attribution rules in the area of options. Section 318(a)(4) provides that an option holder is deemed the owner of the stock under option. Nevertheless, the attribution rule of section 318 has been interpreted not to apply to corporate reorganizations because that section is not located in the same subchapter.⁴¹

3. *Intention To Control.* Perhaps the most difficult criterion in ascertaining control is the intent of the parties to control the transferee after the reorganization. There should be a bona fide intent to control the transferee. This is not to say that the control may not be relinquished shortly thereafter; indeed, the timing of the relinquishment is of minor importance. Several tests come to mind in this regard. Could the reorganization have been accomplished without relinquishing control? Was there a contract present requiring divestiture of the controlling interest? Other questions delve into the substantive heart of the reorganization. Did the stockholders intend to keep control from the outset, or bail out after the reorganization? Could the end result of the reorganization be obtained without surrendering control?

If a reorganization conceivably may be consummated with the requisite control, that will probably constitute patent satisfaction of section 368(c). But if the intentions of the transferors from the beginning are that the con-

³⁶ *American Bantam Car Co.*, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950); *Louangel Holding Corp. v. Anderson*, 9 F. Supp. 550 (S.D.N.Y. 1934).

³⁷ *James Q. Newton Trust*, 42 B.T.A. 473 (1940), *aff'd*, 122 F.2d 416 (10th Cir. 1941), *cert. denied*, 315 U.S. 802, *aff'd sub nom. Helvering v. Cement Investors, Inc.*, 316 U.S. 527 (1942).

³⁸ *C.T. Inv. Co. v. Commissioner*, 88 F.2d 582 (8th Cir. 1937).

³⁹ *See, e.g., TEX. BUS. CORP. ACT ANN.* art. 2.22 (1969). A majority of states have similar laws.

⁴⁰ *Commissioner v. National Bella Hess, Inc.*, 220 F.2d 415 (8th Cir. 1955), *aff'g* 20 T.C. 636 (1953).

⁴¹ *Hyman H. Berghash*, 43 T.C. 743 (1965).

trolling shares will be sold in a public offering, then control immediately after the reorganization will be found lacking.⁴² This is perhaps another occasion to apply the step transaction principle—control is not deemed conclusive at any intermediate step in the reorganization, but rather at the completion of the overall plan.⁴³

A finding of lack of intent to control is by no means limited to the situation of a public offering. Control may be transferred to a third party, who in turn effects a sale to an outside group. If disposition is contemplated from the origination of the plan, and such disposition forms an integral part of the reorganization, control immediately after the transfer will not be found.⁴⁴

A recent ruling is indicative of this point. In Revenue Ruling 70-225⁴⁵ the taxpayer proposed a (D) reorganization qualifying under section 355. The stock received in the spin-off was to be transferred in a subsequent (B) reorganization with another corporation as part of the overall plan. The Service ruled that the requisite control was lacking, since the taxpayer never intended to retain it, but instead to dispose of it immediately in the subsequent (B). The transaction could not be salvaged under section 351 because that section also looked to section 368(c) for the definition of control. Moreover, the (B) transaction would not stand on its own since it was viewed as a transfer of assets to the ultimate transferee corporation, rather than as an acquisition by that transferee of all the stock of a previously existing corporation in exchange for its own voting stock. Not only would the fair market value of the stock distributed be deemed taxable to the shareholder, but gain would also be recognized to the distributing corporation on the transaction.⁴⁶

4. *The Binding Commitment.* Closely associated with the determination of the intentions of the transferor is the search by the courts for a binding commitment to divest control of the transferee. If such a commitment is found in any part of the reorganization plan, control will not be found.⁴⁷ An example of this type of agreement is in the delivery of the greater part of the controlling stock interest to outsiders upon receipt of the stock after the reorganization.⁴⁸

The elusive thing about the binding commitment requirement is that it has no time limit for upsetting control. As long as the commitment is present,

⁴² *Overland Corp.*, 42 T.C. 26 (1964). In this particular case the "intentions" were reinforced by a court order providing for a sale. The court also noted that without a public sale to raise additional capital, the reorganization would have been fruitless.

⁴³ *Overland Corp.* cited as authority for this principle *Bassick v. Commissioner*, 85 F.2d 8 (2d Cir. 1936), *aff'g* 30 B.T.A. 163 (1934), *cert. denied*, 299 U.S. 592 (1936). Much to the same effect is *American Wire Fabrics Corp.*, 16 T.C. 607 (1951), where momentary control was in the transferor, but it was part of the overall plan to dispose of it.

⁴⁴ *Maine Steel, Inc. v. United States*, 174 F. Supp. 702 (S.D. Me. 1959).

⁴⁵ 1970 INT. REV. BULL. No. 19, at 15.

⁴⁶ An almost identical fact situation occurred in Rev. Rul. 54-96, 1954-1 CUM. BULL. 111, the "basis" part of that ruling modified in Rev. Rul. 56-100, 1956-1 CUM. BULL. 624.

⁴⁷ The Tax Court made this broad explanation in *American Bantam Car Co.*, 11 T.C. 397, 405-06 (1948), for its holdings in *Hazeltine Corp. v. Commissioner*, 89 F.2d 513 (3d Cir. 1937), and *Bassick v. Commissioner*, 85 F.2d 8 (2d Cir. 1936).

⁴⁸ *Commissioner v. Schumacher Wall Board Corp.*, 93 F.2d 79 (9th Cir. 1937), *aff'g* 33 B.T.A. 1211 (1936). A similar holding is in *Manhattan Bldg. Co.*, 27 T.C. 1032 (1957), *acquiesced in*, 1957-2 CUM. BULL. 5.

the reorganization control is not measured until its fulfillment.⁴⁹ If, after satisfying the commitment to divest, control is present, then there is no problem. As in *Halliburton v. Commissioner*,⁵⁰ control may be held for twenty-two days, yet if it must be contractually divested at the end of that time, the reorganization will fail to qualify. *Halliburton* involved the incorporation of a partnership under an agreement to convey more than the controlling interest to seven oil companies.⁵¹ The same theory was applied to a contract with an underwriter to dispose of control by public trading, even though control was maintained for three weeks after the transaction was consummated.⁵²

5. *Momentary Control.* It would seem at first blush that if a holding period of three weeks will not suffice, how could anything less qualify? However, absent a commitment to dispose of control, instantaneous or even momentary control will satisfy section 368(c).

The First Circuit found no trouble with momentary control in *Portland Oil Co. v. Commissioner*.⁵³ The court placed emphasis on the lack of obligation to sell the controlling interest to third persons, and even remarked in dictum that it should make no difference if the transferor is already under a previous contractual obligation to convey stock to a third person at the time it is received.⁵⁴ However, this posture has not been tolerated by the majority of decisions on this point. As noted, a previous commitment to divest control is destructive of a valid reorganization.⁵⁵

Another situation that comes dangerously close to nonqualification is one in which the taxpayer is not bound to give away control, but does so immediately after the consummation of the reorganization. This occurred in *Wilgard Realty Co. v. Commissioner*.⁵⁶ The taxpayer conveyed the controlling stock interest by gift to relatives on the day of receipt. The court found no difficulty in sustaining control in the taxpayer. It even went so far as to state that it would be immaterial whether the taxpayer had a preconceived plan to dispose of the controlling interest, absent a binding obligation to do so.⁵⁷ This reasoning may be tolerable, but it does not explore in depth the intentions from the beginning of the reorganization. It may be permissible to change one's mind subsequently, or to have an unforeseeable change of circumstances cause loss of control immediately after the transaction, but it is quite another thing to ignore the taxpayer's *ab initio* intent to divest himself of control.

⁴⁹ 3 J. MERTENS, *supra* note 30, § 20.91, at 421.

⁵⁰ 78 F.2d 265 (9th Cir. 1935).

⁵¹ Note that this case did not involve a reorganization, but rather the equivalent of a § 351 transaction, *i.e.*, incorporation of a going concern. The law today is that incorporating a business for no other purpose than to qualify for a reorganization is not sufficient. *West Coast Marketing Corp.*, 46 T.C. 32 (1966).

⁵² *Hazeltine Corp. v. Commissioner*, 89 F.2d 513 (3d Cir. 1937), *rev'g on other grounds* 32 B.T.A. 110 (1935).

⁵³ 109 F.2d 479 (1st Cir.), *cert. denied*, 310 U.S. 650 (1940), *aff'g* 38 B.T.A. 757 (1938).

⁵⁴ 109 F.2d at 490.

⁵⁵ See note 47 *supra*, and accompanying text.

⁵⁶ 127 F.2d 514 (2d Cir.), *cert. denied*, 317 U.S. 655 (1942).

⁵⁷ *Id.* at 516. The court placed the basic distinction between this and *Bassick v. Commissioner*, 85 F.2d 8 (2d Cir. 1936), and *Hazeltine Corp. v. Commissioner*, 89 F.2d 513 (3d Cir. 1937), in the transferor's basic freedom of choice to do what he liked with the control.

6. *Creditors*. Debt holders of a corporation are not equity holders in the strict sense of the word. The history of all types of reorganizations is fraught with the interjection of bonds, notes, debentures, etc., in place of equity shares, so that continuity of interest may become obscured to the point of nonqualification. Control by creditors has presented no less a problem.

In *Commissioner v. Cement Investors, Inc.*⁵⁸ the Tenth Circuit regarded bondholders as stockholders in a (D) reorganization, finding that they had acquired an equitable interest in the property and, therefore, had supplanted the stockholders. Thereafter, the Supreme Court in *Helvering v. Southwest Consolidated Corp.*⁵⁹ refused to hold that bondholders could be regarded as stockholders for purposes of control in a reorganization under the Revenue Act of 1934.

A slight inroad into the holding of *Southwest* was made in the later Sixth Circuit opinion of *Sieberling Rubber Co. v. Commissioner*.⁶⁰ The petitioner corporation possessed an unsecured indebtedness from another corporation in which it held a controlling interest. The Sixth Circuit, reversing the Tax Court, held that a (D) reorganization took place even though there was an indebtedness exchanged for a stock interest. *Southwest* was not even cited in the majority opinion.⁶¹

The *Sieberling* case did not regard as material the fact that the petitioner-stockholder was largely a creditor of the company to which the assets were transferred. The main interest transferred was that of the indebtedness, and such interest constituted "property" in the eyes of the court and qualified the transaction even under section 112(b)(5) of the Revenue Act of 1934.⁶² The court observed:

[I]t makes no difference whether control was retained by the old stockholders, in their capacity as such stockholders, or because of the fact that they were creditors. It is enough that the persons having control of the new company were former stockholders, although they received the stock in the new company resulting from the reorganization in their capacity as creditors of the old company.⁶³

Sieberling and *Southwest* may be distinguished on the basis that a pure creditor situation will not succeed, yet a mixture of shareholders and creditors

⁵⁸ 122 F.2d 380 (10th Cir. 1941).

⁵⁹ 315 U.S. 194 (1942), *rev'g* 119 F.2d 561 (5th Cir. 1941). The Court made this statement, 315 U.S. at 202:

Indeed Clause C contemplates that the old corporation or its shareholders, rather than its creditors, shall be in the dominant position of 'control' immediately after the transfer and not excluded or relegated to a minority position. Plainly, the normal pattern of insolvency reorganization does not fit its requirements.

⁶⁰ 169 F.2d 595 (6th Cir. 1948).

⁶¹ It was cited in the dissent, *id.* at 606, for the proposition that bondholders, not the stockholders, received controlling interest in the new corporation.

⁶² This section is the forerunner of INT. REV. CODE of 1954, § 351, permitting individuals or partnerships, like corporations, to change the form of doing business tax free, although not constituting a reorganization because the transferors may not be corporations. Moreover, there is no distribution mechanism in § 351 as in a qualified (D) reorganization.

⁶³ 169 F.2d at 598. Cited as authority for this statement was *Prairie Du Chien-Marquette Bridge Co. v. Commissioner*, 142 F.2d 624 (3d Cir. 1944); *accord*, *Commissioner v. Huntzinger*, 137 F.2d 128 (10th Cir. 1943).

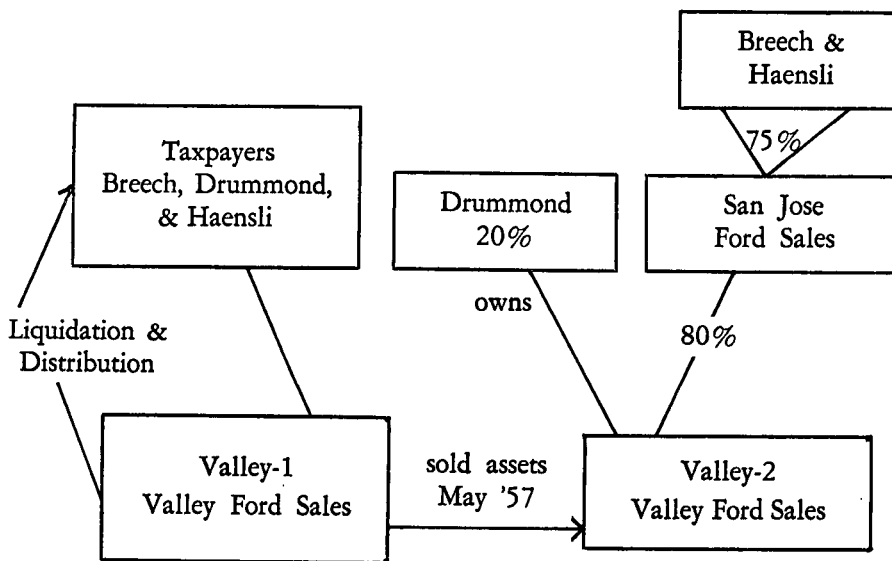
will. The distinction is, however, doubtful at best, and can only serve as a caveat to the draftsman of a reorganization.

7. *Third-Party Control*. Logic would dictate that control in the hands of parties foreign to the original transfer would disturb the qualification of the reorganization. Yet if the third party is used as an "accommodation" to the transaction, and there is no intent for the third party to own or possess the control stock for more than the time necessary to perform his function, control will not be disturbed.⁶⁴

The third-party control argument may come in handy to tax counsel in opposing a liquidation-reincorporation⁶⁵ attack by the Service. The taxpayer may argue that the control requirements are *not* met if more than the necessary percentages are in the hands of outside third parties. But to succeed in such argument, the taxpayer must not fall into the trap of *Reef Corp.*⁶⁶ The stockholders in that case "sold" their stock to a trustee. The trustee did not negotiate, furnish consideration of his own, or incur personal liability. The Tax Court sustained the Commissioner in declaring the trustee to be a mere conduit, and that no valid sale was intended. The trustee could, therefore, acquire no control: the old stockholders had the requisite control before and after the transaction.

The most recent authoritative interpretation of section 368(c) control in (D) reorganization appeared in *Breech v. United States*.⁶⁷ A complex inter-relationship of corporations and shareholder ownership is described in the following diagram.

BREECH DIAGRAM



⁶⁴ Handbird Holding Corp., 32 B.T.A. 238 (1935).

⁶⁵ Liquidation-reincorporation problems are treated in section IV *infra*.

⁶⁶ 24 CCH Tax Ct. Mem. 379 (1965).

⁶⁷ 439 F.2d 409 (9th Cir. 1971). *Breech* was apparently consolidated with *Drummond* on the Government's appeal.

The central issue was whether eighty percent control under section 368(c) was present so as to qualify a (D) reorganization. The Government contended that a sale of assets of Valley-1 to Valley-2 constituted a (D) reorganization. The subsequent distribution to the shareholders would constitute boot under section 356 and be taxable as a dividend to them to the extent of Valley-1's accumulated earnings and profits.⁶⁸ To reach the requisite eighty percent control, the Government read the (D) phrase "any combination thereof" to refer to the stockholders of the transferor corporation. The argument ignored the ownership by San Jose, and the shareholders of San Jose were deemed part of the combination to meet the eighty percent requirement.

The court found the argument unpersuasive. It noted that the attribution rules of section 318 were not applied by Congress to cases of this sort. Reference was even made to the 1939 Code section 112(g)(1)(D), which required that the control rest "in the transferor or its shareholders or both." The court believed that the phrase "any combination thereof" meant that some, rather than all of the transferor's shareholders could combine with the transferor to comply with the eighty percent rule.⁶⁹

8. *Creeping Control*. The ordinary method of acquiring control is by obtaining the stock or securities in a single transfer from the transferee. If a small percentage of control is acquired from a previous transaction, or a series of transactions, "creeping" control results.⁷⁰ This is permissible in (D) reorganizations. It was allowed in a reorganization in which over seventy percent of the assets of the new corporation were acquired by cash purchase nearly a year before the reorganization.⁷¹

Creeping control is no defense to a liquidation-reincorporation attack by the Service. It is not a valid argument that control of the transferee must be acquired in the transfer process. The *existence* of control over the transferee by the transferor or its shareholders immediately after the transfer is all that is required.⁷²

9. *Attribution*. The attribution rules of section 318 do not apply to stock control in corporate reorganizations. This principle was dramatically noted in *Drummond v. United States*.⁷³ The Commissioner mounted a liquidation-reincorporation attack against the taxpayer's claimed section 331 liquidation. The court found the liquidation bona fide and the requisite control lacking. It did not apply the attribution rule in section 318, but stated that the applicable attribution rule was that of section 368(c).⁷⁴ *Drummond* fails to give any reasons for this attribution conclusion. Section 368(c) does not of itself

⁶⁸ *Id.* at 411. The opinion omits the section under which a (D) formally must qualify by definition, *i.e.*, §§ 354, 355, or 356. If the (D) indeed is deemed "qualified" under § 356 for boot treatment, and, therefore, dividend in this case, how is the transaction classified as a tax-free reorganization in the first place, *viz.*, § 368(a)(1)(D)?

⁶⁹ Quoted as authority was S. REP. NO. 1622, 83d Cong., 2d Sess. § 368 (1954).

⁷⁰ "Creeping" control is mentioned in B. BITTKER & J. EUSTICE, *FEDERAL TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 14.13 (3d ed. 1971).

⁷¹ *Commissioner v. Bankers Farm Mortgage Co.*, 145 F.2d 772 (7th Cir. 1944).

⁷² *Retail Properties, Inc.*, 23 CCH Tax Ct. Mem. 1463, 1472 (1964).

⁷³ 68-2 U.S. Tax Cas. ¶ 9608, at 88,095 (C.D. Cal. 1968).

⁷⁴ *Id.* at 88,097, Conclusions of Law, ¶ 6.

give any hint as to whom control may be attributed, nor on what basis. The court may have meant there is another attribution rule available for section 368(c); however, it did not name that section. The court was possibly referring to section 368(a)(1)(D), by which the transferor or one or more of its shareholders qualify as owners.

10. *The Government's Position.* The Service's position on the definition of control is expressed in Revenue Ruling 59-259.⁷⁵ In that situation there was more than an eighty percent average ownership of the total number of shares of outstanding nonvoting stock, but ownership of only twenty-two percent of one class of nonvoting stock. This reorganization failed to qualify under section 368(c), which was interpreted to require ownership of at least eighty percent of *each* class of nonvoting stock. It should be noted that averaging may be done in case of voting stock. It is not necessary to own eighty percent of *each* class of *voting* stock.⁷⁶ Some classes of stock are nonvoting in some respects, yet have special voting privileges in others. Which is the proper classification? The Service has taken the position that the right to elect directors is the determinative factor in "voting power."⁷⁷

The Service has made one exception to the stock control requirements. In Federal Housing Administration insured mortgage loans, there is sometimes a requirement in the financing arrangement that a special class of stock be issued to the FHA for security purposes.⁷⁸ These are not regarded as classes of stock for section 368(c) purposes, and no control is needed for a reorganization.⁷⁹

The Service has been anything but consistent in its policy on control. In 1956 the Service allowed a corporation to gain the requisite control *before* the reorganization.⁸⁰ The transferor corporation owned only twelve percent of the preferred stock of the transferee corporation. In order to get the requisite control under section 368(c), the transferee corporation issued additional shares of common to the preferred owners in exchange for the preferred. The transferor corporation then had ninety-three percent of the common, and the necessary control. In 1963, however, the Service rejected a similar attempt to qualify a reorganization by gaining control beforehand. The sole stockholder of one corporation also had thirty percent of another corporation. He gave enough of that stock to his own corporation to give it eighty percent control. The Service referred to the control given the solely-owned corporation as "transitory and illusory," and stated that section 355 does not apply to a transaction where there was an immediately preceding contribution to capital in an attempt to effect a nontaxable distribution.⁸¹

⁷⁵ 1959-2 CUM. BULL. 115.

⁷⁶ See, e.g., Rev. Rul. 63-260, 1963-2 CUM. BULL. 147.

⁷⁷ I.T. 3896, 1948-1 CUM. BULL. 72.

⁷⁸ 24 C.F.R. § 207.18(c) (1971).

⁷⁹ Rev. Rul. 66-333, 1966-2 CUM. BULL. 114.

⁸⁰ Rev. Rul. 56-117, 1956-1 CUM. BULL. 180. Under the 1939 Code it was not permissible to gather control immediately before a reorganization as part of the complete plan. See J. RABKIN & M. JOHNSON, *FEDERAL INCOME, GIFT AND ESTATE TAXATION* § 32.08A (1971).

⁸¹ Rev. Rul. 63-260, 1963-2 CUM. BULL. 147.

Any distinction between the 1956 and 1963 rulings is further confused by a 1969 ruling on the obtention of control before a reorganization.⁸² The same problem existed: only seventy percent control was present. In a tax-free (E) reorganization by the transferee, a recapitalization was accomplished in which class A and B voting stock were issued. The transferor corporation then obtained eighty percent voting control by exchanging common stock for class B voting stock. The class A voting stock was issued to others. The surrender of the common stock by the transferor corporation for the class B stock was a transaction to which section 354 applied. Revenue Ruling 63-260⁸³ was distinguished on the ground that the (E) recapitalization in the instant situation resulted in a permanent realignment of voting control.

The distinction could be cast on other grounds. Both the 1956 and 1969 rulings concerned the use of the reorganization provisions, whereas the 1963 situation involved mere contribution to capital. The distinction may, therefore, be viewed as the procedural manner of qualifying a transaction before the actual reorganization takes place. The distinction cannot be grounded in the use of section 355, because the 1963 ruling and 1969 ruling both involved that Code section. The Service will probably condone the additional control obtained through other corporate reorganizations rather than allow the less subtle means of direct cash acquisition.

The Service frequently takes the position that liquidation-reincorporations occur in commonly-owned corporations where transfers give rise to the occasion. One of the few instances of a happy ending for the taxpayer in a successful liquidation-reincorporation assertion by the Commissioner occurred in Revenue Ruling 57-311.⁸⁴ The two shareholders decided to discontinue doing business in a particular city. One shareholder was to continue the operations under another corporation. The departing shareholder took cash in redemption for his complete holdings in the old corporation, but the amount taken equalled only about ten percent of the value of his shares. He then transferred that cash to a new corporation in exchange for all of its stock.⁸⁵ For no consideration, the old corporation transferred its assets to the new corporation.⁸⁶ The assets transferred were worth approximately the same as the value of the shares previously held by the departing shareholder. The Service treated this transaction as a (D) reorganization, primarily on the basis of the control over both corporations. In the eyes of the Commissioner the old corporation transferred assets to a new corporation in exchange for all the stock of the latter. That stock was then distributed to the retiring shareholder. Since the assets transferred were qualified under the section 355(a) five-year active business requirement, no gain or loss was recognized to shareholder or corporation.

A striking distinction between this ruling and other liquidation-reincorpora-

⁸² Rev. Rul. 69-407, 1969-2 CUM. BULL. 50.

⁸³ 1963-2 CUM. BULL. 147.

⁸⁴ 1957-2 CUM. BULL. 243.

⁸⁵ As an aside, it should be noted that the shareholder obtains complete control of the new corporation under § 368(c).

⁸⁶ If there were more than two shareholders some objection might be made to a transfer without consideration. Picture shareholder reaction to Ford's gratis transfer of assets to General Motors.

tions is that no dividend treatment was given the shareholder on his receipt of cash. Almost without exception liquid assets as well as cash retained on liquidation receive section 356(a)(2) treatment when the (D) is successfully asserted. Good judgment was exercised by the Service in this case, however, for the shareholder did not retain the cash, but plowed it back into the new business.

In Revenue Ruling 70-240⁸⁷ a common owner of two corporations caused one to sell its operating assets to the other and liquidate under section 331. Since the common owner had control of both corporations, the transaction met the qualifications of section 368(a)(1)(D). No additional stock had to be issued; the owner had one hundred percent control. The operating assets were regarded as "substantially all the properties" within the meaning of section 354(b)(1)(A). The earnings and profits of both corporations could be considered for purposes of determining the extent of the dividend distribution under section 356(a)(2).⁸⁸ The cash distribution was, therefore, taxable to the extent of the combined earnings and profits of both corporations. The distinctions between these two rulings are fairly apparent. In Revenue Ruling 70-240 the common owner siphoned off approximately fifty percent of the total assets as a liquidating distribution. Moreover, there was no recited business purpose for the transfer of assets. The position taken by the Service is not unusual.

Yet the Government does not always antagonize sole shareholders in the control of multiple corporations. In Revenue Ruling 70-18⁸⁹ a sole shareholder owned two corporations, which in turn owned a third corporation. The two corporations merged, and distributed the stock of the third to the sole shareholder. The distribution was allowed without recognition of gain under section 355. The Service apparently saw nothing wrong with letting the shareholder own directly what he had previously owned indirectly.

The Government does not view the transfer of cash as a factor disturbing control. Cash transfers arise in (D) reorganizations when two businesses of unequal size must be divided. The Service will allow cash to be transferred in the reorganization to equalize the relative values. The transaction will still qualify as a (D) reorganization under section 355.⁹⁰

B. Plan of Reorganization

Neither the 1939 nor the 1954 Code defines the meaning of a "plan

⁸⁷ Rev. Rul. 70-240, 1970 INT. REV. BULL. No. 20, at 17.

⁸⁸ Cited for authority in the ruling on this point was *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).

⁸⁹ 1970 INT. REV. BULL. No. 2, at 9.

⁹⁰ Rev. Rul. 56-655, 1956-2 CUM. BULL. 214. The allowance of balancing in the (D) in the transfer process is also evidenced in the REPORT OF THE SENATE COMM. ON FINANCE, S. REP. NO. 1622, 83d Cong., 2d Sess. 274 (1954):

Your committee's bill has altered the definition to provide that if the control of the transferee corporation is in the transferor corporation or in persons who were shareholders of the transferor, or any combination thereof, the transfer will, nevertheless, qualify as a reorganization under section 368(a)(1)-(D), the control owned by these persons need not be in the same proportion as it was before the transfer.

of reorganization." The Regulations mention the "plan" twice,⁹¹ but in neither reference can any substantive content or clarification be found. Case law has developed the required elements of the "plan."

The plan of reorganization is a necessary element in any reorganization, (D) or otherwise. Without it no reorganization can occur, whether the taxpayer or the Commissioner is advocating the advent of a reorganization.⁹² Usually, the plan of reorganization will take the form of corporate resolutions and minutes, ordinarily drafted by the parties' attorney. These documents will contain all the elements necessary to accomplish a tax-free reorganization, and will probably be labeled "Plan of Reorganization" to remove a revenue agent's doubts. Even absent such formal preparation, the decisions indicate that a plan can be found in nearly any situation.

1. *Form of Plan.* The Regulations would have us believe there are strict and formal requirements to have a plan.⁹³ The Treasury states that the plan must be adopted by each corporation, and by their responsible officers, and appear upon the official records of each corporation.⁹⁴ The Regulations are silent as to when shareholder approval may be required.

If there is one theme followed by the courts, it is that the plan of reorganization need not be in writing; the actions of the parties speak for themselves.⁹⁵ It is not necessary that there be a formal plan;⁹⁶ it is sufficient if there

⁹¹ The first mention appears under "Definition of Terms" in Treas. Reg. § 1.368-2(g) (1955):

The term 'plan of reorganization' has reference to a consummated transaction specifically defined as a reorganization under section 368(a). The term is not to be construed as broadening the definition of 'reorganization' as set forth in section 368(a), but is to be taken as limiting the non-recognition of gain or loss to such exchanges as are directly a part of the transaction specifically described as a reorganization in section 368(a). Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 368(a), but the readjustment involved in the exchanges or distributions effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 368(a) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms.

The second mention of the plan appears under the heading "Records to be kept and information to be filed with returns" in Treas. Reg. § 1.368-3(a) (1955): "The plan of reorganization must be adopted by each of the corporations parties thereto; and the adoption must be shown by the acts of its duly constituted responsible officers, and appear upon the official records of the corporation." (The Regulation continues with a list of the items to be filed as a part of the income tax return for the year in which the reorganization occurred).

⁹² As is discussed in section IV *infra*, the Commissioner often insists a (D) reorganization occurs when a reincorporation follows a liquidation, or transfers are made from one closely held corporation to another. For a recent example, see Rev. Rul. 70-240, 1970 INT. REV. BULL. No. 20, at 17.

⁹³ Treas. Reg. § 1.368-3(a) (1955), quoted in note 91 *supra*.

⁹⁴ *Id.*

⁹⁵ *Pebble Springs Distillery Co. v. Commissioner*, 231 F.2d 288 (7th Cir. 1956); *Ketler v. Commissioner*, 196 F.2d 822 (7th Cir. 1952); *C.T. Inv. Co. v. Commissioner*, 88 F.2d 582, 585 (8th Cir. 1937) ("It need not be reduced to writing."); *Prentis v. United States*, 273 F. Supp. 460, 475 (S.D.N.Y. 1967) ("it need not be reduced to writing"); *William C. Kind*, 54 T.C. 600, 608 (1970) ("a formal plan need not be adopted"); *James G. Murin*, 24 T.C. 502 (1955) (oral plan); *Peeler Hardware Co.*, 5 T.C. 518 (1945), *aff'd*, 155 F.2d 974 (5th Cir. 1946); *Hortense A. Menefee*, 46 B.T.A. 865, 868 (1942); *Edison Sec. Corp.*, 34 B.T.A. 1188 (1936); *William H. Redfield*, 34 B.T.A. 967 (1936); *Preston Wilson*, 20 CCH Tax Ct. Mem. 676 (1961).

⁹⁶ *Prentis v. United States*, 273 F. Supp. 460 (S.D.N.Y. 1967); *William C. Kind*, 54

are other circumstances that indicate a plan of reorganization exists. These circumstances are largely governed by the existence of intent to reorganize, rather than to liquidate or effect a distribution. A 1937 case provides an example of the judicial attitude toward the plan in construing a (D) reorganization:

We find nothing in the statute prescribing that the plan of reorganization must be in any particular form. It need not be reduced to writing. It may be amended as circumstances dictate. But when carried out, it must leave the transferor with an interest in the transferee, and this interest must be definite and material, and must represent a substantial part of the thing transferred⁹⁷

2. *Intent.* As mentioned, the reorganization will not stand or fall on the form of the transaction, but the intent of the parties to reorganize will be regarded with utmost significance. It is generally from the acts of the parties that the courts deduce their intent in any given transaction.⁹⁸ But the requisite intent will not be found if other purposes for the transaction exist that supersede or control the parties' actions.⁹⁹ If the intent is to accomplish a purchase or sale rather than a reorganization, the plan will fail.¹⁰⁰ The same result is reached when the intent is to achieve a bona fide liquidation.¹⁰¹ Similarly, the intent to form a plan will be found lacking if the transaction takes place at a point in time when an intent to reorganize could not have been formed.¹⁰² A subsequent disposition of the stock acquired in a reorganization will not defeat it if it was not intended originally as part of the plan of reorganization.¹⁰³

3. *Contents.* Ideally the plan should contain all the essential elements of a reorganization. These would include (1) the assets to be transferred, (2) the stock or securities received on the exchange, (3) the amount of shares distributed to each shareholder, and whether any shares are to be redeemed from the shareholders in the exchange,¹⁰⁴ and (4) the business purpose and

T.C. 600 (1970); Ethel K. Lesser, 26 T.C. 306 (1956); Transport Prods. Corp., 25 T.C. 853, 858 (1956); James G. Murrin, 24 T.C. 502 (1955); Charles R. Mathis, Jr., 19 T.C. 1123, 1128 (1953) (dictum that it is unnecessary for the plan to be written and incorporated into the minutes of the corporation).

⁹⁷ C.T. Inv. Co. v. Commissioner, 88 F.2d 582, 585 (8th Cir. 1937).

⁹⁸ American Potash & Chem. Corp. v. United States, 185 Ct. Cl. 161, 168, 399 F.2d 194, 199, *motion to vacate opinion denied*, 185 Ct. Cl. 161, 402 F.2d 1000 (1968):

Taxpayer's intent is considered in determining the existence of an overall plan to accomplish a particular result by a series of steps and in determining the existence of a plan to reorganize. The existence of either a plan to reorganize or a plan to accomplish a particular end result, however, does not necessarily mean that the particular route chosen to accomplish the desired result qualifies as a reorganization, as that term is defined in the statute.

See also Charles R. Mathis, Jr., 19 T.C. 1123 (1953); Wilgard Realty Co., 43 B.T.A. 557 (1941), *aff'd*, 127 F.2d 584 (2d Cir.), *cert. denied*, 317 U.S. 655 (1942).

⁹⁹ Charles R. Mathis, Jr., 19 T.C. 1123 (1953).

¹⁰⁰ Caldwell v. United States, 30 F. Supp. 308 (M.D. Pa. 1939), *aff'd on other grounds*, 114 F.2d 995 (3d Cir. 1940); Huey & Philp Hardware Co., 40 B.T.A. 781 (1939).

¹⁰¹ Cushman Motor Works v. Commissioner, 130 F.2d 977 (8th Cir. 1942), *aff'g sub nom.* Charles D. Ammon, 44 B.T.A. 1288 (1941); Sharp v. United States, 263 F. Supp. 884 (S.D. Tex. 1966).

¹⁰² John Levene, 3 CCH Tax Ct. Mem. 800 (1944).

¹⁰³ Robert Campbell, 15 T.C. 312 (1950), *acquiesced in*, 1951-1 CUM. BULL. 1.

¹⁰⁴ In a "spin-off" no shares need be surrendered by the shareholders; in a "split-off"

facts leading up to the proposed reorganization. The contents of the plan are important for the additional reason that they determine who are parties to the reorganization.¹⁰⁵

The courts have often found the contents of a reorganization plan when no plan was intended. A plan of complete liquidation sufficed as the contents of a plan in *Retail Properties, Inc.*¹⁰⁶ A contract for the acquisition of additional shares of one of the parties to a merger qualified as a plan in *Rawco, Inc.*¹⁰⁷

4. *The "Steps."* As mentioned, an unwritten plan will not defeat a reorganization if the necessary elements are present. To find a plan of reorganization among several transactions the courts have resorted to the "step transaction" doctrine. Accordingly, the plan is found among the several "steps" taken by the parties to achieve the end result. If the steps are "successive," rather than "independent," a reorganization plan may be found—even against the taxpayer's wishes.¹⁰⁸ The step transaction doctrine has also been labeled the "single transaction" doctrine,¹⁰⁹ but the meaning is the same.

The Tax Court seems to place greater emphasis on the first and last steps to determine if a reorganization was intended.¹¹⁰ Yet, if the circumstances so warrant, the Tax Court will view the detailed steps in their entirety¹¹¹ to ascertain if the steps in reality are parts of an integrated transaction.¹¹² The steps constituting the plan do not have to be performed in any given time period, but should have some degree of continuity or reflect a consistency in performance of the plan.¹¹³ It is extremely helpful if the steps must be taken under some form of legal compulsion,¹¹⁴ such as a contract or court order, as the end result can be said to have been "planned" from the beginning.

5. *Amendment.* It appears to be settled that a plan or reorganization may be amended when the circumstances so dictate.¹¹⁵ But a change of the plan is shares in the transferor corporation are exchanged for the distributed shares of the transferee corporation to which the assets were transferred.

¹⁰⁵ Robert Campbell, 15 T.C. 312 (1950); see *Anheuser-Busch, Inc.*, 40 B.T.A. 1100 (1939), *aff'd*, 115 F.2d 662 (8th Cir. 1940), *cert. denied*, 312 U.S. 699 (1941); *George D. Graham*, 37 B.T.A. 623 (1938). See also 3 J. MERTENS, *supra* note 30, § 20.95.

¹⁰⁶ 23 CCH Tax Ct. Mem. 1463 (1964).

¹⁰⁷ 37 B.T.A. 128 (1938). See also *Watts v. Commissioner*, 75 F.2d 981 (2d Cir.), *aff'd*, 296 U.S. 387 (1935).

¹⁰⁸ *Swanson v. United States*, 70-2 U.S. Tax Cas. ¶ 9624 (E.D. Cal. 1970).

¹⁰⁹ *Rinkel v. Knox*, 196 F. Supp. 21, 24 (D. Minn. 1961): "It is the government's position that all the steps in this attempted reorganization plan constituted a single transaction arising out of an integrated plan."

¹¹⁰ *Ethel K. Lesser*, 26 T.C. 306, 311 (1956): "We may examine the first and the last in the series of transactions in order to decide whether or not a reorganization was effected." *William M. Liddon*, 22 T.C. 1220, 1225 (1954): "When we must determine whether there has been a reorganization, a liquidation, a sale, or an exchange in a series of transactions, it is proper for us to look at the beginning and end of the series."

¹¹¹ *Howard Hotel Corp.*, 39 B.T.A. 1147, 1153 (1939).

¹¹² *Retail Properties, Inc.*, 23 CCH Tax Ct. Mem. 1463 (1964). See also *Ketler v. Commissioner*, 196 F.2d 822, 826 (7th Cir. 1952): "Our inquiry must be whether the transactions were so related that they possessed an integrated tax significance or whether each was so isolated and independent as to give rise to a separate tax consequence."

¹¹³ *Hortense A. Menefee*, 46 B.T.A. 865, 868 (1942).

¹¹⁴ *United States v. Arcade Co.*, 203 F.2d 230 (6th Cir.), *cert. denied*, 346 U.S. 828 (1953).

¹¹⁵ *C.T. Inv. Co. v. Commissioner*, 88 F.2d 582, 585 (8th Cir. 1937); *Brown v. Heiner*, 15 Am. Fed. Tax R. 899 (W.D. Pa. 1933); cf. *John C. Shaffer*, 28 B.T.A. 1294 (1933); *Wm. Hewitt*, 19 B.T.A. 771 (1930). See also 3 J. MERTENS, *supra* note 30, § 20.64.

to be distinguished from a change of circumstances. In *Giles E. Bullock*¹¹⁶ a sale by one of two common shareholders so changes the circumstances that the transaction could not be carried out according to the original plan, and was, therefore, deemed a partial liquidation.

6. "*In Pursuance of.*" The existence of the plan is necessary, but compliance with the plan is required as well. The transfer or exchange must be made *pursuant to* the plan of reorganization.¹¹⁷ Two criteria have been suggested in determining whether an exchange is pursuant to the reorganization plan: (1) it should be germane to the business of one corporate party to the reorganization; or (2) it should effect a readjustment of interests in the corporate parties to the reorganization.¹¹⁸ If a major shareholder does not accept the plan, and deals individually with the transferor, the transaction will be taxable because it was not in pursuance of the plan of reorganization.¹¹⁹ Likewise disqualified from the reorganization shelter was a preliminary exchange of stock between two shareholders of the parties to the reorganization.¹²⁰ The reorganization was tax-free, but the exchange was not pursuant to the plan of reorganization. It was viewed as an adjustment between two shareholders and not protected by the reorganization that followed.

7. *Time.* There seems to be no limitation on the amount of time the plan of reorganization may be in effect before being fully consummated. One reorganization plan was in existence fifteen years before completion.¹²¹ The plan had the advantage of being court-approved in connection with an insolvency reorganization. In *Roosevelt Hotel Co.*¹²² the indenture trustee took possession of the corporate property and held it for four years before a plan of reorganization was adopted. The court observed that there is nearly always a delay before bondholders and creditors arrive at a satisfactory solution, and noted that a delay of eighteen months was tolerated by the Supreme Court in *Helvering v. Alabama Asphaltic Limestone Co.*¹²³ Recently a lapse of three years has been declared not too lengthy for a (C) reorganization to take place, citing an example¹²⁴ wherein five years elapsed and the reorganization was still valid.¹²⁵

¹¹⁶ 26 T.C. 276 (1956), *aff'd per curiam*, 253 F.2d 715 (2d Cir. 1958).

¹¹⁷ *Prentiss v. United States*, 273 F. Supp. 460 (S.D.N.Y. 1967).

¹¹⁸ Manning, 'In Pursuance of the Plan of Reorganization': *The Scope of the Reorganization Provisions of the Internal Revenue Code*, 72 HARV. L. REV. 881 (1959).

¹¹⁹ *Wm. Hewitt*, 19 B.T.A. 771 (1930), *appeal dismissed*, 76 F.2d 1011 (2d Cir. 1935). It is to be remembered that under the 1939 Code, with regard to spin-offs, § 112(b)(11) provided for nonrecognition of gain to shareholders who receive stock in a party to the reorganization "in pursuance of the plan or reorganization," without their surrender of any stock. Int. Rev. Code of 1939, ch. 521, § 112(b)(11), 65 Stat. 493 (1951); Revenue Act of 1932, ch. 209, § 112(g), 47 Stat. 197.

¹²⁰ *Edison Sec. Corp.*, 29 B.T.A. 483 (1933), *aff'd in part and remanded*, 78 F.2d 85 (4th Cir. 1935). To the same effect is *Walter B. Lashar*, 34 B.T.A. 768 (1936), where the taxpayer made a sale of stock received in a reorganization independent of the plan; gain was recognized on the transaction. See also 3 J. MERTENS, *supra* note 30, § 20.64: the exchange must be made in *pursuance of* the plan, not *because of* the plan.

¹²¹ *Pearson Hotel, Inc. v. United States*, 199 F. Supp. 33 (N.D. Ill. 1959).

¹²² 13 T.C. 399 (1949).

¹²³ 315 U.S. 179 (1942).

¹²⁴ *D.W. Douglas*, 37 B.T.A. 1122 (1938).

¹²⁵ *Preston Wilson*, 20 CCH Tax Ct. Mem. 676 (1961).

The closer the instances occur in time, the stronger is the inference that the transactions were part of a plan.¹²⁶ The spread of the steps of the plan over a period of time will not be material, "so long as the steps [are] a consistent performance of the reorganization plan and purpose."¹²⁷

As stated, the events and transactions must be in pursuance of the plan. Stated conversely, the plan should not be adopted after the occurrence of the events. Yet one (D) reorganization seemingly has violated this rule. In *Morley Cypress Trust, Schedule "B"*¹²⁸ the equal shareholders of a timber corporation received liquidating distributions over a four-year period. In the last year oil was discovered. A new corporation was formed. The assets of the timber corporation were issued to the new corporation in exchange for stock of the latter. The Tax Court held that all the factors of a reorganization were present. The fact that the old corporation was in the process of liquidation did not defeat reorganization.

The more logical rule was stated recently in *Nadeau v. United States*.¹²⁹ If the plan was adopted subsequent to the events constituting the reorganization, the steps taken were done in pursuance of the plan, and accordingly no reorganization will be found.¹³⁰

8. *Third Parties.* The presence of third parties is not fatal to a plan of reorganization. In the liquidation-reincorporation areas the taxpayer's argument that conveyance to or from the parties disqualify the reorganization is usually not sustained.¹³¹ In an insolvency reorganization the passage of the property through a bondholder's committee in the course of a transfer from the old corporation to the new did not prevent the transaction from being a reorganization, since it was merely a transitory step.¹³² If it is part of the plan that trustees or creditors take temporary possession of the assets while a new corporation is formed, the reorganization will still qualify.¹³³

C. Parties to a Reorganization

In addition to having control and a plan, the taxpayer must also be a party to the reorganization. To oversimplify the matter, only parties to the reorganization receive the tax-free treatment of exchanges of stock and assets, as well as receipts of worthy emoluments from other parties to the reorganization.

The Code definition of the (D) reorganization does not contain language concerning the parties to a reorganization. Subsection (b) of section 368 does, however, give a definition of the parties for purposes of all six basic types. The first portion only of this subsection is applicable to the (D):

¹²⁶ *Love v. Commissioner*, 113 F.2d 236, 238 (3d Cir. 1940).

¹²⁷ *Hortense A. Menefee*, 46 B.T.A. 865, 868 (1942).

¹²⁸ 3 T.C. 84 (1944). Cited as authority were *Love v. Commissioner*, 113 F.2d 236 (3d Cir. 1940); *Anna V. Gilmore*, 44 B.T.A. 881 (1941).

¹²⁹ 181 F. Supp. 752 (W.D. Mich. 1960).

¹³⁰ *Id.*

¹³¹ *Ethel K. Lesser*, 26 T.C. 306 (1956); *Bard-Parker Co.*, 18 T.C. 1255, *aff'd*, 218 F.2d 52 (2d Cir. 1954).

¹³² *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942).

¹³³ *Adamston Flat Glass Co. v. Commissioner*, 162 F.2d 875 (4th Cir.), *cert. denied*, 332 U.S. 809 (1947); *cf. Standard Coal, Inc.*, 20 T.C. 208 (1953).

"[T]he term 'a party to a reorganization' includes—(1) a corporation resulting from a reorganization, and (2) both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another."¹⁸⁴

A corporation resulting from the reorganization may be a newly created corporation to which assets are transferred in exchange for the controlling interest of the transferee.¹⁸⁵ It may also consist of two corporations in a "split-up" wherein the old corporation ceases to exist and the assets are transferred to two other corporations.¹⁸⁶

Plainly, paragraph (2) is descriptive of the (D) reorganization with respect to the language "acquisition by one corporation of stock or properties of another." In the (D) the transferor acquires the stock of the other in exchange for assets. By the same token, the transferee is acquiring property of the transferor, so there is certainly no quarrel that both corporations are parties to the reorganization.

The Regulations do not clarify the parties in the (D) reorganization. Purporting to define a "party to the reorganization" for all six types, section 1.368-2(f) states only this language with respect to the (D):

Both corporations are parties to the reorganization if Corporation M transfers all or a part of its assets to Corporation N in exchange for all or a part of the stock and securities of Corporation N, but only if (1) immediately after such transfer, Corporation M, or one or more of its shareholders (including persons who were shareholders immediately before such transfer), or any combination thereof, is in control of Corporation N, and (2) in pursuance of the plan, the stock and securities of Corporation N are transferred or distributed by Corporation M in a transaction in which gain or loss is not recognized under section 354 or 355, or is recognized only to the extent provided by section 356.¹⁸⁷

Since this part of the Regulation merely repeats the language of subparagraph (D), whether subsidiaries or multiple corporations may be used under the 1954 Code and Regulations is apparently an open question.

Subparagraphs (C) and (D) under section 368(a)(2) allow transfers of assets or stock to subsidiaries in certain (A), (B), and (C) situations, as well as the use of a controlling corporation's stock in a statutory merger. Omitted is whether a (D) reorganization may permit transfers or the use of stock or property on the part of either transferor or transferee before the qualifying distribution under sections 354, 355, or 356.

It should be recalled that prior to the 1954 Code there was no provision requiring the distribution of the stock or securities received by the transferor from the transferee. Court decisions did permit more than two corporations to be parties to a reorganization under the 1939 Code. But if the 1954 Code requires that the securities received be distributed under sections 354, 355, or 356, how can subsidiaries or parents become parties to the (D) reorganiza-

¹⁸⁴ INT. REV. CODE of 1954, § 368(b).

¹⁸⁵ Old or new, § 368(c) control is still required. *See also* B. BITTKER & J. EUSTICE, *supra* note 70, § 13.01.

¹⁸⁶ B. BITTKER & J. EUSTICE, *supra* note 70, § 13.01.

¹⁸⁷ Treas. Reg. § 1.368-2(f) (1966).

tion? Apparently they may participate only as shareholders. A parent may receive the stock of the transferee in a distribution by the subsidiary-transferor under section 354, but its participation is that of a shareholder of the transferor, and not that of a "party" to the reorganization.

There is perhaps one technical situation in which the parent controlling the (D) transferor is literally a party under the (D) definition. If the parent also owns stock in the transferee before the transfer, then as a shareholder together with the transferor (its subsidiary), the control test of section 368(c) is met. If the parent were not a shareholder of the transferee preceding the transfer, it would not be a party to the reorganization. Its only participation would be the receipt of the stock or securities under sections 354 or 355.

Bittker suggests another manner in which subsidiaries may be used in a (D) reorganization.¹³⁸ Assuming a parent owns all the stock of a subsidiary, this stock may be transferred to another corporation (the transferee) in exchange for controlling interest in the latter. The stock of the subsidiary is an asset in the hands of the parent, and can thus qualify as the "asset" in a (D) reorganization that may be transferred to the transferee. The parent and the transferee are clearly parties to the reorganization under section 368(b)(2), but is the subsidiary whose stock was used as the asset being transferred? Apparently it is, since it also falls within the liberal definition of section 368(b)(2): the transferee is acquiring *stock* of the subsidiary, which at the same time is *property* of the parent corporation. But if by some stretch of the imagination the subsidiary is not a party, the transaction is not affected because the parent is still undeniably a party to the reorganization.¹³⁹

Revenue Ruling 57-465¹⁴⁰ affirmed this use of a subsidiary to accomplish a (D) reorganization which involved foreign corporations attempting a merger. Since the (A)-type merger provision contemplates only mergers effected under the laws of the United States, states, territories, or the District of Columbia,¹⁴¹ the transaction would have to qualify under another subparagraph. The parent corporation was a domestic corporation owning all the outstanding stock of a foreign subsidiary corporation, which in turn owned all the outstanding stock of another foreign corporation of the same country. This latter stock was the principal asset of the first subsidiary. For valid business reasons the first subsidiary merged into its wholly owned subsidiary. The ruling treated this situation as a (D) reorganization qualifying under section 354(a)(1).

The unusual feature of the ruling is that it treats the transferor as being the first subsidiary under the parent corporation, rather than the parent itself. The parent could be viewed as the transferor, and the asset transferred as the first subsidiary's stock. Instead the ruling treats the asset transferred as the second subsidiary's stock, which the second subsidiary will receive upon the merging of the first subsidiary into it. The stock of the survivor (the second subsidiary) is then distributed under section 354(a)(1) to the parent corpora-

¹³⁸ B. BITTKER & J. EUSTICE, *supra* note 70, § 14.32.

¹³⁹ By virtue of INT. REV. CODE of 1954, § 368(b)(2).

¹⁴⁰ 1957-2 CUM. BULL. 250.

¹⁴¹ See Treas. Reg. § 1.368-2(b) (1966).

tion, who takes it as a shareholder—not a party to the reorganization—but from a party to the reorganization.

It is difficult to justify the decision that the asset transferred is the survivor's stock. The ruling recites that the stock will only be cancelled so that new shares are issued in their place. Has the survivor really received anything at all for the newly issued shares? The language of the ruling reflects a lack of consideration of this question: "In the instant case, the principal asset of Y corporation (its stock of Z corporation), while it will be transferred to Z corporation, will be transferred only for cancellation and will not be received or held by Z corporation as an asset."¹⁴²

The contrary argument has substantial merit—even using the authorities cited by the ruling.¹⁴³ In *Helvering v. Schoellkopf*¹⁴⁴ an (A) merger was rejected on substantially the same pattern, but a (D)¹⁴⁵ was upheld. The transfer of additional assets, admittedly of little value, together with the stock was sufficient to qualify the transaction. In *Helvering v. Leary*¹⁴⁶ the Fourth Circuit held that both an (A) and (D) reorganization took place on substantially the same facts. No importance was placed upon the fact that the transferee received its own stock in the transaction. The court also noted that the various subdivisions of reorganizations do overlap.¹⁴⁷

(D) reorganizations involving subsidiaries are not well defined in the Code or case law. It would always be advisable to seek a ruling from the national office before proceeding if it seems that a subsidiary might not be a party to the reorganization.

D. "Substantially All"—Section 354(b)(1)(A)

The (D) definition speaks of the necessary transfer of assets as only "all or part." It is only by reference to one of the qualification sections, section 354, that the term "substantially all" is found. Section 354(b)(1)(A) carves out an exception to the qualification of exchanges under section 354(a) in (D) reorganizations unless "(A) the corporation to which the assets are transferred acquires *substantially all* of the assets of the transferor of such assets"¹⁴⁸ As in other instances, the Code does not define "substantially all." The regulations paraphrase the Code, but add that section 354 is not precluded from application to the (D) reorganization if the properties retained or received in the exchange are used to satisfy existing liabilities incurred in the ordinary course of business before the reorganization.¹⁴⁹

¹⁴² 1957-2 CUM. BULL. 252.

¹⁴³ *Helvering v. Schoellkopf*, 100 F.2d 415 (2d Cir. 1938). Judge Learned Hand stated, *id.* at 416:

The taxpayer argues that the New York company acquired all the properties of the Maryland company when that company transferred to it its own shares and the miscellaneous assets. As to the shares we do not agree; the shares of a company, when transferred to itself cannot properly be regarded as property acquired; the shares are merely extinguished.

¹⁴⁴ 100 F.2d 415 (2d Cir. 1938).

¹⁴⁵ The (D), of course, was not of that letter in 1939. The provision was then under the Revenue Act of 1928, ch. 2, § 112(i)(1)(B), 45 Stat. 791.

¹⁴⁶ 93 F.2d 826 (4th Cir. 1938).

¹⁴⁷ *Id.* at 828, citing *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935).

¹⁴⁸ INT. REV. CODE of 1954, § 354(b)(1)(A) (emphasis added).

¹⁴⁹ Treas. Reg. § 1.354-1(a)(2) (1966).

A recent Ninth Circuit case, *Moffatt v. Commissioner*,¹⁵⁰ has held that a specific percentage of assets need not be transferred. On this issue "the nature of the properties retained by the transferor, the purpose of retention, and amount thereof"¹⁵¹ became important. The *Moffatt* court based its decision upon a revenue ruling¹⁵² interpreting the phrase "substantially all the properties" in a (C) reorganization. The ruling would not apply a mechanical test to the language in a (C) reorganization, and apparently such a test will not be applied in section 354(b)(1)(A) for (D) reorganizations. The dissent in *Moffatt* noted that under the 1939 Code "substantially all of the properties" meant at least eighty percent of the properties, including the intangibles.¹⁵³ The percentage of assets transferred was only 64.52 percent, which, the dissent argued, did not constitute "substantially all."

Section 354(b)(1)(A) and *Moffatt* were construed subsequently in *Oscar E. Baan*¹⁵⁴ and were held not to be applicable to that fact situation. The court made the distinction on the basis that the transfer involved only the operating assets of one business, while other operating assets were retained and utilized in the remaining business. *James Armour, Inc.*¹⁵⁵ interpreted the "substantially all" requirement of section 354(b)(1)(A) as necessitating the transfer of all the assets essential to the conduct of the business enterprise. It should be noted that nonessential assets, unnecessary for the conduct of a business, that are retained or distributed to the shareholders will only serve to contrast and point up the "essentiality" of the assets transferred.¹⁵⁶

The decisions indicate that the key to "substantially all" is the transfer of "operating assets." Once there has been such an exchange or transfer, section 354(b)(1)(A) is satisfied. If an essential operating asset is retained, the "substantially all" requirement is not met. The Court of Claims recently made this latter finding in *Ross Michael Simon Trust v. United States*.¹⁵⁷ The retention of cash was regarded as an essential operating asset because the purported transferee could not bid on future construction work without a cash reserve.¹⁵⁸ The Court of Claims opinion seemingly agreed with *Moffatt*, noting in dicta that in service businesses such as those in *Moffatt*, the operating assets essential to a business may be its employees, and their transfer may constitute "substantially all" of the assets.¹⁵⁹

¹⁵⁰ 363 F.2d 262 (9th Cir. 1966), *aff'd* 42 T.C. 558 (1964), *cert. denied*, 386 U.S. 1016 (1967).

¹⁵¹ 363 F.2d at 267.

¹⁵² Rev. Rul. 57-518, 1957-2 CUM. BULL. 253.

¹⁵³ See authorities collected at 363 F.2d at 270.

¹⁵⁴ 51 T.C. 1032, 1040 (1969).

¹⁵⁵ 43 T.C. 295 (1964).

¹⁵⁶ As stated in Ralph C. Wilson, Sr., 46 T.C. 334, 346 (1966): "That all of the assets needed in the conduct of Associates' business were transferred to Agency can also be shown by an examination of the assets *not* transferred."

¹⁵⁷ 185 Ct. Cl. 291, 402 F.2d 272 (1968).

¹⁵⁸ Several recent decisions have interpreted the "substantially all" requirement to necessitate the transfer of liquid assets. In *Simon v. United States*, 185 Ct. Cl. 291, 307, 402 F.2d 272, 280 (1968), the Court of Claims equated liquid assets and operating assets. In a more recent case, *Swanson v. United States*, 70-2 U.S. Tax Cas. ¶ 9624 (E.D. Cal. 1970), the Government contended that the taxpayer's § 337 liquidation and subsequent reincorporation was in fact a (D), (E), or (F) reorganization. The district court noted that the liquid assets of the old corporation were not transferred to the new. Thus the "substantially all" requirement for the (D) was not met. *Id.*

¹⁵⁹ 185 Ct. Cl. at 307, 402 F.2d at 280.

A safe harbor for those not wishing to speculate on the requirements of transferring "substantially all" the assets is found in Revenue Procedure 66-34.¹⁶⁰ The Service takes the position that the "substantially all" requirement of section 354(b)(1)(A) "is satisfied if there is a transfer of assets representing at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by the corporation immediately prior to the transfer."¹⁶¹

A ruling pursuant to this revenue procedure is obviously not open to the taxpayer who becomes the subject matter of a liquidation-reincorporation contention by the Commissioner. Such was the occasion in the recent Tax Court case of *Mark DeGross*.¹⁶² The taxpayer had three corporations, and attempted a liquidation under sections 331 and 346. The sales operation of the liquidated corporation was transferred to another controlled corporation without business interruption. The principal contention of the taxpayer to defeat the application of the "substantially all" requirement was that an exclusive license agreement had not been transferred. The court noted that the taxpayer retained sufficient control over his enterprises to allow the transferee merely to infringe on the license agreement without a formal transfer. The court cited instances in which intangible assets not appearing on a corporation's balance sheet may properly be taken into account in determining whether the "substantially all" requirement has been met.¹⁶³

In *Reef Corp.*¹⁶⁴ the Tax Court held that the "substantially all" requirement of section 354(b)(1)(A) was met notwithstanding the fact that a large amount of cash had been borrowed and distributed to the shareholders before the main transfer of assets.¹⁶⁵

To transfer "substantially all" the assets it is not required that a transferee receive its own stock in the transaction. This argument was advanced by the taxpayer in *Retail Properties, Inc.*¹⁶⁶ but was rejected by the Tax Court, which observed that four out of five total parcels of rental realty were transferred to a subsidiary. The fact that stock was a nonoperating asset was enough for the court to disregard its nontransfer, even though the value of the stock exceeded the value of the real estate.

DeGross and *Retail Properties, Inc.* demonstrate the ease with which the transfer of "substantially all" the assets can be facilitated when the Commissioner is so asserting. The other cases are indicative of judicial attitude in marginal cases—when the taxpayer is advocating compliance with section 354. A good business purpose for the retention of liquid assets, or even essential assets, will furnish no justification for failure to transfer what the court may ultimately find to be "substantially all" the assets.

¹⁶⁰ 1966-2 CUM. BULL. 1232. The Service will follow certain operating rules in issuing ruling letters, as outlined in this procedure.

¹⁶¹ *Id.* at 1233.

¹⁶² 54 T.C. 59 (1970).

¹⁶³ *Id.* at 73; John G. Moffatt, 363 F.2d 262 (9th Cir. 1966); Ralph C. Wilson, Sr., 46 T.C. 334, 345-48 (1966).

¹⁶⁴ 24 CCH Tax Ct. Mem. 379 (1965).

¹⁶⁵ *Id.* at 395.

¹⁶⁶ 23 CCH Tax Ct. Mem. 1463, 1472 (1964).

III. COMPARISONS WITH OTHER REORGANIZATION TYPES

1. *The (A) Reorganization.* Section 368(a)(1)(A) is a statutory merger or consolidation.¹⁶⁷ One basic requirement of the merger for tax purposes is that its accomplishment be recognized under state law.¹⁶⁸ The manner in which the acquisition (or exchange or transfer) is accomplished is liberally defined, and cash, securities, preferred, etc., may be used to gain the necessary interest under state law needed for the merger. The shareholders of the old corporation become shareholders of the new in a tax-free exchange of stock or securities. How, then, are the (D) and (A) comparable?

The similarity can be close, depending on the completion of the reorganization. As an example, Revenue Ruling 58-93¹⁶⁹ involved the formation of a new subsidiary to which a seventy-nine percent owned subsidiary transferred all its assets, and then merged with its parent. The Service treated this as a valid (A) reorganization, and regarded the transaction as if the parent had transferred the assets to the new subsidiary.¹⁷⁰ But a (D) reorganization could not have been completed by a distribution of the new subsidiary stock under sections 354 or 355 because eighty percent control was lacking.

An (A) merger became a (D) reorganization in Revenue Ruling 57-465.¹⁷¹ A foreign subsidiary of a domestic parent merged into its subsidiary. The foreign subsidiary's principal asset (the stock of its own subsidiary) was transferred to that subsidiary in exchange for shares in it. The Regulations do not allow a merger unless effected pursuant to the laws of the United States, state, or territory, or the District of Columbia.¹⁷² But since the second subsidiary was acquiring "substantially all" the assets of the first, the requirements of section 354(b) were met for the (D) to be qualified.

It is also permissible to use an (A) merger with a (D) reorganization. In *Commissioner v. W. Morris Trust*¹⁷³ a (D) reorganization qualifying under section 355 took place immediately before a merger. Part of the business of the state bank transferor needed to be spun off before a merger with a national bank to comply with national banking laws. The fact that the state bank did not survive the merger would not preclude the (D) and (A) combination from qualifying.¹⁷⁴

Finding a (D) reorganization in a typical merger situation as in Revenue Ruling 57-465 is unique. It is an exceptional circumstance that will probably not occur except in the instance of foreign subsidiaries. Even without this exception, the substantial overlap between these types can cause differing tax treatment depending on the final label used. The use of another type of

¹⁶⁷ In a merger one of the parties survives, the other goes out of existence. In a consolidation, both parties go out of existence. A new corporation takes the place of both.

¹⁶⁸ See Edward H. Russell, 40 T.C. 810, 822 (1963).

¹⁶⁹ 1958-1 CUM. BULL. 188.

¹⁷⁰ The Service noted that under INT. REV. CODE of 1954, § 368(a)(2)(C) the parent may transfer the assets acquired in a merger to a new subsidiary, but that this usually occurred *after* the reorganization, not before.

¹⁷¹ 1957-2 CUM. BULL. 250; see note 143 *supra*.

¹⁷² Treas. Reg. § 1.368-2(b) (1966).

¹⁷³ 367 F.2d 794 (4th Cir. 1966).

¹⁷⁴ *Id.* The court noted that there was no requirement of continuing control of the transferor which went out of existence. The control of the "spun-off" business was still maintained in the old shareholders on the receipt of stock in the transaction.

reorganization in conjunction with a (D) reorganization as accomplished in *Morris Trust* may be hazardous. As will be seen below, the other reorganization may divest the transferor of control, or it may be deemed one step in a step transaction asserted by the Service. Any number of evils can befall the planner unless the pattern has been positively established.

2. *The (B) Reorganization.* Section 368(a)(1)(B) is defined as the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such corporation. The principal difference between the (D) and (B) reorganization is that various assets are used in the (D) for the acquisition, whereas the (B) uses voting stock only.

In some circumstances the (B) and (D) reorganizations can look alike. The 1964 amendment to section 368 allows a corporation to use the stock of its parent in a (B) reorganization. Since this stock might also constitute "assets" that could be used in a (D) reorganization, the pattern seems similar. However, the (D) reorganization must go one step further: it must be qualified under sections 354 or 355. If the stock of the parent constituted "substantially all" the assets of the subsidiary, and the stock received were distributed under section 354, the transaction would fit both (B) and (D). A (B) reorganization does not require, however, that the stock of the transferee be distributed. But section 354 does not preclude a voluntary distribution if the other requirements of a reorganization are accomplished.

The (D) and (B) combination arose recently in Revenue Ruling 70-225¹⁷⁵ in which a corporation spun off assets of one business to a subsidiary, qualifying under section 355, and distributed the stock to the sole shareholder of the parent. As part of the plan the sole shareholder exchanged the subsidiary stock with an unrelated corporation in which he received less than controlling interest. The latter transaction was intended to meet the (B) requirements. Neither reorganization qualified. The (D) reorganization failed because control was not obtained under section 368(c). It was part of the plan that control of the subsidiary would be lost in the subsequent (B) reorganization that followed. The (B) part of the reorganization did not qualify because it was viewed, in effect, as a transfer of assets by the parent corporation to the unrelated corporation for a part of the latter's stock, thus failing as a stock-for-stock (B) transaction.¹⁷⁶

Revenue Ruling 70-225 should be contrasted with Revenue Ruling 70-434.¹⁷⁷ In this latter ruling a corporation operated two businesses, only one of which was attractive to a prospective acquiring corporation. To divest itself of the undesirable business, the corporation spun off the undesirable business, representing twenty-three percent of the assets, to a newly created corporation and distributed the stock to its shareholders in a qualifying (D) reorganization. The acquiring corporation then obtained all the stock of the target corporation in exchange for its voting stock. The Service ruled that

¹⁷⁵ 1970 INT. REV. BULL. No. 19, at 15.

¹⁷⁶ 1954-1 CUM. BULL. 111, as modified with respect to the basis in Rev. Rul. 56-100, 1956-1 CUM. BULL. 624.

¹⁷⁷ 1970 INT. REV. BULL. No. 34, at 11.

the latter transaction was a (B) reorganization. It curiously added the language that the stock of the newly created corporation distributed to the target company's shareholders was not property of the acquiring corporation.

The rulings are quite similar in principle, achieve the same intended business purpose, but differ in result. Why is not the loss of control of the target corporation in Revenue Ruling 70-434 interpreted in the manner of Revenue Ruling 70-225? After their (D) reorganizations, both corporations lost independent control in a (B) reorganization. The two rulings may be reconciled superficially, but substantive distinction appears to be lacking. The acquiring corporation did not acquire eighty percent of the target corporation, taking into account the spun-off assets. Revenue Ruling 70-225 and Revenue Ruling 70-434 cannot be distinguished on the basis of the lack of foreseeable planning, since both envisaged disposition of more than eighty percent control from the beginning. The distinction simply does not appear within the present refinements of reorganization law.

3. *The (C) Reorganization.* Section 368(a)(1)(C) is defined as an acquisition by an acquiring corporation of substantially all of the properties of another corporation, in exchange solely for voting stock of the acquiring corporation or its parent. In the (C) reorganization the acquiring corporation may also use a limited amount of cash or corporate property with the voting stock.

In the instance of a (C) and (D) overlap, the Code has come to the rescue. Section 368(a)(2)(A) states that if the transaction is described in both the (C) and (D) definitions it will be treated as a (D) reorganization. Seemingly the reason for section 368(a)(2)(A) is that Congress intended section 355 to apply notwithstanding the fact that no distribution of the transferee's stock subsequently ensued.¹⁷⁸

4. *The (E) Reorganization.* Section 368(a)(1)(E) is defined simply as "a recapitalization." Bittker lists four methods by which a recapitalization may occur.¹⁷⁹ Generally the capital structure is changed in the (E) reorganization. The (D) and (E) reorganizations are totally dissimilar since there is no acquiring or acquired corporation; the new corporation is merely a "reincarnation"¹⁸⁰ of the old.

5. *The (F) Reorganization.* A reorganization under section 368(a)(1)(F) is defined as "a mere change in identity, form or place of organization, however effected." In a sense, all reorganizations are changes in minor form and would seem to fit the definition of (F). In previous examples whether a reorganization qualifies under one subsection or another has generally been immaterial. Differentiation between (D) and (F) reorganizations becomes material insofar as application of other Code sections is concerned. For example, section 381(b) applies restrictions to (F) types but not to (D) re-

¹⁷⁸ Goldman, *The (C) Reorganization*, 19 TAX L. REV. 31, 39 (1963).

¹⁷⁹ B. BITTKER & J. EUSTICE, *supra* note 70, § 14.17.

¹⁸⁰ *Id.* at n.92.

organizations. Congress apparently believed that a change of accounting procedure would be authorized when the business form is changed substantially, but not when the substance of the organization remains unchanged.¹⁸¹

Section 1244(d)(2) also applies a different rule to (F) reorganizations. Stock received in an (F)-type reorganization in exchange for stock meeting the other requirements of section 1244 is treated as meeting such requirements.

In the comparison between (D) and (C) reorganizations it was seen that section 368(a)(2)(A) made the (C) a (D) if it could also qualify under that type. There is no analogous Code section for the (D) and (F). But Revenue Ruling 57-276¹⁸² states that if a reorganization will meet the requirements of subsections (A), (C), or (D), and also qualify as an (F), the Service will regard it is an (F) reorganization.

IV. LIQUIDATION-REINCORPORATION

The (D) reorganization can be a sword in the hands of the Commissioner as well as a shield for the taxpayer. The game is played in the following manner. The taxpayer liquidates his corporation under section 331. The assets received are deemed in full payment for the shares exchanged. Normally the holding period is long enough for the taxpayer to realize long-term capital gains. If the fact situation stops here, no problem exists. But if the taxpayer causes the operating assets to be reincorporated, or vested in a corporation in which he or his group maintain control, a section 368(a)(1)(D) reorganization occurs. Any assets not reincorporated and left in his hands are taxed as a dividend under section 356(a)(2).

Any involuntary (D) situation will involve (1) a liquidation of a controlled corporation, and (2) the transfer of the operating assets to another controlled corporation. There may or may not be retention of nonessential or liquid assets for the Commissioner to assert as a dividend, but normally the taxpayer keeps something.

The case law is that any particular situation qualifies as a (D) reorganization because section 354 is satisfied. The transfer of the *operating* assets, though in some instances admittedly less than even half, nevertheless qualifies, because a transfer of "substantially all" the assets under section 354 means only the essential or operating assets.¹⁸³ No percentage test is involved.

But the courts are not as lenient in the control test for application of the involuntary (D) reorganization. Section 368(c) says eighty percent, and the decisions agree. Any less control in the taxpayer is not sufficient for a reorganization.¹⁸⁴

Similarly, the courts have no difficulty in finding a plan of reorganization. Taking all the steps of the taxpayer as an integrated effort to reach a final result, a plan can be found.¹⁸⁵ As mentioned previously, there is no requirement that the plan be in writing.

¹⁸¹ See the discussion in *Reef Corp. v. Commissioner*, 368 F.2d 125, 136 (5th Cir. 1966).

¹⁸² 1957-1 CUM. BULL. 126.

¹⁸³ See section II(D) *supra*.

¹⁸⁴ See, e.g., *Drummond v. United States*, 68-2 U.S. Tax Cas. ¶ 9608 (C.D. Cal. 1968).

¹⁸⁵ See, e.g., *Abegg v. Commissioner*, 429 F.2d 1209 (2d Cir. 1970).

The courts have not found it necessary for a taxpayer to receive any new stock. If the taxpayer has actual control, such a requirement would amount to an honoring of form over substance.¹⁸⁶ No Code section defines the situation in which a liquidation-reincorporation will be found. The Regulations do warn of a situation in which a reincorporation is likely to exist. Section 1.331-1(c) states:

A liquidation which is followed by a transfer to another corporation of all or part of the assets of the liquidating corporation or which is preceded by such a transfer may, however, have the effect of the distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized only to the extent of 'other property.' See sections 301 and 356.¹⁸⁷

A recent revenue ruling, however, has given fair notice of the type of situation in which the Service will find a (D) reorganization. In Revenue Ruling 70-240¹⁸⁸ a sole shareholder of two corporations, X and Y, caused X to sell its operating assets to Y for cash at their fair market value. X liquidated under section 331, and Y continued to operate the business assets formerly operated by X. The sole shareholder received the cash for all his stock in X. According to the Treasury's position a (D) reorganization took place. Since the sole shareholder owned all the stock of Y, there would be no necessity of receiving additional shares. The transfer of the operating assets would be sufficient to qualify as transferring "substantially all" the assets under section 354(b)(1).¹⁸⁹ The cash received is gain recognized under section 356(a)(1), and treated as a dividend under section 356(a)(2) to the extent of the combined earnings and profits of both corporations.¹⁹⁰

It should be stated at this point that not all liquidation-reincorporations arise under subsection (D). Subsections (E) and (F) have also been recently used in the courts¹⁹¹ as well as the Revenue Rulings. If the eighty percent required control factor is missing from a likely candidate for a reorganization, the Service will apply subsections (E) and (F). In Revenue Ruling 61-156¹⁹² the shareholders of the selling corporation owned only forty-five percent of the stock of the purchasing corporation. The other fifty-five percent was sold to the public by underwriters. This was held to be a reorganization under both subsections (E) and (F). The boot kept by the shareholders in the transfer process was taxed under section 356(a)(2).

The Service will also decline to rule in areas of liquidation followed by a

¹⁸⁶ *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir.), *cert. denied*, 368 U.S. 836 (1961); *Ralph C. Wilson, Sr.*, 46 T.C. 334 (1966).

¹⁸⁷ *Treas. Reg. § 1.331-1(c)* (1966).

¹⁸⁸ 1970 INT. REV. BULL. No. 20, at 17.

¹⁸⁹ The Ruling cites on this point *Rev. Rul. 57-518*, 1957-2 CUM. BULL. 253; *John G. Moffatt*, 42 T.C. 558 (1964), *aff'd*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967).

¹⁹⁰ The theory of looking to the earnings and profits of both corporations, rather than just the earnings and profits of X, comes from *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967). The application of *Davant* to this situation is rather liberal since that case involved a situation in which it was rather difficult to ascertain from which corporation earnings and profits had been exacted. Here it is rather obvious that the sole shareholder received his distribution from corporation X.

¹⁹¹ See *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967) (holding both for a (D) and (F)).

¹⁹² 1961-2 CUM. BULL. 62.

reincorporation of all or part of the assets, or in instances in which the liquidation is followed by a sale of the corporate assets by the shareholders to a corporation in which the shareholders own more than a nominal amount of stock.¹⁹³

One manner of defeating an involuntary reorganization under subsection (D) is simply to not have eighty percent control¹⁹⁴ after the completion of the transfer. It worked for the taxpayers before the Tax Court in *Joseph C. Gallagher*,¹⁹⁵ *Austin Transit, Inc.*,¹⁹⁶ and in a California district court in *Drummond v. United States*.¹⁹⁷

The variations of the liquidation-reincorporation system are manifold, but reach the same result. The first corporation may liquidate and then transfer the assets to the new corporation;¹⁹⁸ it may also sell the assets, then liquidate and transfer either directly¹⁹⁹ to a new corporation, or to the shareholders who then effect the transfer to a controlled corporation. It may be that the transferee corporation will be eventually liquidated after the receipt of operating assets and distribution of stock to the shareholders. In that event the distribution will be taxed as a dividend.²⁰⁰ But even if there is a sale of assets to a related corporation, followed by the transferor's liquidation, the (D) reorganization will be defeated if the former shareholders are not in control.²⁰¹

It has been stated that the 1954 Code dampened the Commissioner's use of subsection (D) in the liquidation-reincorporation arena.²⁰² This observation is based on the addition of the language in the (D) definition which compels a distribution to qualify under sections 354, 355, or 356. This contention should be taken for face value only. Qualification under section 354 is extremely easy—especially when one is not trying. The transfer of "substantially all" the assets, as required by section 354(b)(1)(A), has been interpreted as only the *operating* assets, and this generally occurs. Liquid and nonessential assets are siphoned off. Again, the plan need not be in writing, the stock does not have to be issued, and the same business need not be conducted by the transferee corporation. The additional hurdle does not appear to be too high for the Government to overcome. This argument is buttressed by the recent holdings in *Davant v. Commissioner*,²⁰³ and *Reef Corp. v. Commissioner*.²⁰⁴ *Davant* involved a fact situation that closely resembled a sham,

¹⁹³ Rev. Proc. 62-32, 1962-2 CUM. BULL. 528, § 3.01, ¶ 11.

¹⁹⁴ As required by INT. REV. CODE of 1954, § 368(c).

¹⁹⁵ 39 T.C. 144 (1962), *appeal dismissed*, Nos. 18844, 18845 (9th Cir., Sept. 19, 1963).

¹⁹⁶ 20 T.C. 849 (1953), *acquiesced in*, 1954-1 CUM. BULL. 3. The taxpayer won by only 11%. Only 69% control existed after the transfer in the transferors.

¹⁹⁷ 68-2 U.S. Tax Cas. ¶ 9608 (C.D. Cal. 1968).

¹⁹⁸ As accomplished in *Richard H. Survaunt*, 5 T.C. 665 (1945), *aff'd*, 162 F.2d 753 (8th Cir. 1947).

¹⁹⁹ *William M. Liddon*, 22 T.C. 1220 (1954), *rev'd on other grounds*, 230 F.2d 304 (6th Cir.), *cert. denied*, 352 U.S. 824 (1956).

²⁰⁰ *Ernest F. Becher*, 22 T.C. 932 (1954), *aff'd on other grounds*, 221 F.2d 252 (2d Cir. 1956).

²⁰¹ *David T. Grubbs*, 39 T.C. 42 (1962). In this instance the shareholders of the transferor came up with only 72% control in the transferee.

²⁰² See BUREAU OF NATIONAL AFFAIRS, TAX MANAGEMENT PORTFOLIO NO. 128, CORPORATE ACQUISITIONS—(D) AND (F) REORGANIZATIONS, at A-35 (1966).

²⁰³ 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).

²⁰⁴ 368 F.2d 125 (5th Cir. 1966). But with *Davant* and *Reef Corp.* compare *Pride-mark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965). No reincorporation was held to exist in the latter case. The grounds expressed, *id.* at 41, were "because the transactions were

and *Reef Corp.* was not much better. It took no stretch of the imagination for the appellate courts in each instance to find the scheme necessary for the (D) reorganization.

Not all liquidation-reincorporations have unhappy endings for taxpayers. In at least one instance it worked to the taxpayer's advantage. In Revenue Ruling 57-311²⁰⁵ a shareholder had his stock redeemed by the corporation for approximately ten percent of its value. A new corporation was organized, to which the shareholder transferred the cash received for his shares in exchange for all the stock of the second corporation. The first corporation then transferred certain operating assets to the second corporation without receiving any consideration. At this point the shareholder's stock in the second corporation had substantially the same value as in the first corporation. On these facts the Service held that a (D) reorganization had taken place. The position of the Service was that there had been a transfer of assets from the first corporation to the second, followed by a distribution of the stock of the second to the shareholder in exchange for his stock in the first corporation. No gain or loss was recognized to any of the parties.

Admittedly the transaction was more of a redemption from the shareholder than a liquidation. But, nevertheless, one wonders why the Service did not take the position that the transfer of assets without consideration to the second corporation was not a capital contribution. There was no ownership of the second corporation's stock by the first corporation, nor by any shareholder, since the redeemed shareholder no longer held any interest in the first corporation.

The ruling is also rather exceptional because the cash withdrawal escaped taxation both as a dividend and as a capital gain. Instances are few and far between in which a taxpayer may withdraw cash without tax effects.

The Service will not always argue that a liquidation-reincorporation occurs. The strategy is slightly hazardous if the courts do not find (1) substantially all the assets transferred, (2) a plan, (3) control, and (4) lack of business purpose in the new corporation. A better plan for the Service may be to deny the existence of a valid liquidation in the first place. Any distributions to the shareholders without the protective covering of the full or partial liquidation provisions²⁰⁶ would be susceptible to dividend taxation.²⁰⁷

The Tenth Circuit seems to view liquidation-reincorporations as "reincarnations." Recently in *Babcock v. Phillips*²⁰⁸ a national bank was formed to take over a state bank's fiduciary assets. The same amounts of stock held by the shareholders in the state bank were held in the national bank. The state bank was liquidated, and the capital not needed by the national bank was distributed to the shareholders. The court held that the national bank was the reincarnation of the state bank, and that a (D) reorganization took place.

not motivated by a desire to avoid the payment of taxes." *Id.* at 40 added in dictum that the effectiveness of the (D) was reduced by the Revenue Act of 1954 because of the addition of the "substantially all" requirement of § 354(b)(1)(A).

²⁰⁵ 1957-2 CUM. BULL. 243.

²⁰⁶ INT. REV. CODE of 1954, §§ 331, 346, *inter alia*.

²⁰⁷ As did occur in *Bazley v. Commissioner*, 331 U.S. 737, *rehearing denied and opinion amended*, 332 U.S. 752 (1947).

²⁰⁸ 372 F.2d 240 (10th Cir. 1967).

The amounts distributed from the state bank constituted boot and were taxed accordingly under section 356. *Babcock* did reveal that the Tenth Circuit would not follow *Davant* literally. Though *Davant* found a reorganization, nevertheless, it applied section 301 as the applicable distribution section instead of the usual section 356.²⁰⁹ *Babcock* cited *Davant*, but applied the customary section 356 after finding the (D) reorganization.

A bona fide sale will not amount to a liquidation-reincorporation. In *Allied Stores Corp.*²¹⁰ the parent liquidated the subsidiary because of a debt owed to the latter. The assets were then sold for cash at their fair market value to another subsidiary. The Tax Court found no liquidation-reincorporation.

There is an obvious need for legislative clarification in this area. The situation arises any time a practitioner in good faith observes section 331 and incorporates the assets again. No tax avoidance may have been intended. In the final analysis the taxpayer is punished by the conjunctive use of Code sections. A clear-cut policy of liquidation-reincorporation could be delineated by defining the interval between liquidation and transfer to another corporation that should be observed to escape liquidation-reincorporation. A period of six months would appear to be a reasonable interval. Any business assets that are not actively put to use in this period of time would lose a substantial portion of their value. A second matter capable of definition is the percentage of assets necessary to be transferred before a liquidation-reincorporation attack may be sustained. Presently the courts refuse to use any mathematical test. The only standard is the transfer of "operating" assets—whatever that may be. A transfer of a set percentage, or the lack of it, would give the taxpayer firm grounds for planning his tax affairs.

V. INTERACTION OF THE (D) AND OTHER CODE SECTIONS

The (D) reorganization affects and is affected by other Code sections. In particular, the following sections are analyzed because of their material influence on the tax aspects of (D) reorganizations. Some sections, notably section 354 and the basis sections, are dealt with in other areas of this Article.²¹¹

1. *Section 337.* Closely related to the liquidation provisions of section 331 is section 337. This provision allows the sale or exchange of properties without gain or loss within a twelve-month period if accompanied by a complete liquidation of assets. In the instance of a purchase of a subsidiary corporation the basis in the assets becomes the same as the purchase price paid for the stock, not the basis of the assets to the corporation.²¹² The (D) interaction comes into play when the assets obtained are transferred to an existing corporation or to

²⁰⁹ If INT. REV. CODE of 1954, § 301 is utilized, there is full tax on any distribution. *Id.* § 356, however, recognizes that there is a basis for part of the distribution and taxes only the excess—the "boot."

²¹⁰ 19 CCH Tax Ct. Mem. 1149 (1960).

²¹¹ See sections II(D) *supra* and V(9) *infra*.

²¹² INT. REV. CODE of 1954, § 334(b)(2). If there is a liquidation of the parent, *id.* § 334(a) gives fair market value as the basis in the hands of the distributee.

a new entity formed for the purpose of receiving the section 337 assets. Obviously if a reorganization is held to have taken place, the basis provision pertaining to reorganization (section 362) must be used. The old basis of the assets in the transferor corporation becomes the basis for the assets in the transferee.

This precise situation arose in *Griswold v. Commissioner*.²¹³ The taxpayers attempted to come under section 337, but made the mistake of contractually agreeing to keep the corporation viable, instead of liquidating it to obtain the assets.²¹⁴ The court made reference to *Davant*, *Reef*, and *Babcock*, and concluded that a (D) and (F) reorganization had taken place.²¹⁵

But a valid section 337 liquidation did take place in *Rommer v. United States*²¹⁶ in connection with a plan of complete liquidation of the corporation. Within twelve months after the adoption of the plan the corporation exchanged a luxury apartment house for a low-rent tenement house and cash. The tenement house and cash were distributed to the shareholders proportionately, but five days later the tenement house was conveyed to a new corporation formed for the purpose of receiving it. The Commissioner contended that a (D) reorganization had been effected.

The trial court was convinced that not only had a valid section 337 liquidation taken place, but that the (D) reorganization failed because of noncompliance with section 354. The tenement house represented only nine percent of the total value of the transferor's assets. This could not constitute a transfer of "substantially all" the assets in compliance with section 354(b)(1)(A). There even existed a valid business reason for putting the tenement house in a corporation.²¹⁷

The opinion would have been far more exciting reading if the court had not found for the taxpayer on both major issues. If there had been both a valid section 337 liquidation and compliance with section 354(b)(1)(A), what result? The tenor of the opinion²¹⁸ suggests that the emphasis on the validity of a section 337 liquidation would leave the court no choice but to disregard the contention of a subsequent reorganization. Moreover, the court would be at perfect liberty to omit any findings of a step transaction leading to the (D) reorganization.

Ordinarily if a section 337 liquidation is attempted and a (D) reorganization is found instead, the taxpayer will have some relief because of the non-recognition section of section 361(a). But if a foreign corporation is involved, section 367 requires that a ruling be obtained before the non-recognition provided in section 361 becomes applicable. Failure to do so will cause recognition of gain on the exchange in spite of a valid (D) reorganization.²¹⁹

²¹³ 400 F.2d 427 (5th Cir. 1968).

²¹⁴ A learned accountant had correctly advised them on compliance with § 337, but the advice was not followed.

²¹⁵ As far as any trend is concerned, it appears that courts are regarding it necessary for some unknown reason to hold that not one but two reorganizations take place. Where a (D) is found, seemingly the (F) follows.

²¹⁶ 268 F. Supp. 740 (D.N.J. 1966).

²¹⁷ The shareholders did not want to have their names associated with the property or to incur any contingent personal liability from direct ownership.

²¹⁸ Such as the unnecessary discussion by the court at 268 F. Supp. at 745.

²¹⁹ Werner Abegg, 50 T.C. 145 (1968), *aff'd*, 429 F.2d 1209 (2d Cir. 1970).

2. *Section 355.* The very definition of the (D) reorganization relates to qualification under section 355.²²⁰ The section does not exist merely as an accommodation to the (D); rather it may operate regardless of whether a (D) reorganization is in the making.²²¹ The theory and purpose of section 355 is to set the ground rules for the distribution of stock or securities of a controlled corporation that the transferor has obtained to the latter's shareholders. The distribution may take one of three forms: spin-off, split-off, or split-up.

To "spin off" stock of the transferee the transferor distributes that stock to its shareholders without requiring an exchange of any sort. The stock distributed need not be in proportion to the holdings in the transferor.²²² The "split-off" is the same thing, except the shareholders exchange their stock in the transferor for the newly distributed transferee-controlled corporation stock.²²³ A "split-up" is the formation of two controlled corporations to which the assets of the transferor are transferred. The stock of the two transferees is then distributed to the shareholders of the transferor in exchange for their stock. In this latter situation, as well as in a spin-off, the transferor liquidates.²²⁴

(a) *The Code Requirements.* Section 355 also has its own built-in limitations on the procedures to be followed. Subparagraph (B) of section 355-(a)(1) proscribes transactions that are used principally as a device for the distribution of earnings and profits of either the transferor or transferee. This is obviously a somewhat less than objective test, which causes the whole transaction to suffer unnecessary scrutiny. One of the purposes of the reform in reorganizations in subchapter C of the 1954 Code was to bring about an element of certainty. To subject the transaction to a subjective test of whether a transaction is a "device" leaves much to be desired from the corporate planner's standpoint.

A second limitation subject to the same criticism is contained in clause (ii) of section 355(a)(1)(D). Any retention of stock by the distributing corporation will be subject to the satisfaction of the Secretary or his delegate that no plan existed having as one of its principal purposes the avoidance of the federal income tax. Some conceptual difficulties arise as to how federal income taxes could be avoided. If the stock or securities are retained rather than distributed, the shareholders still retain the same relative book value of their

²²⁰ If the reorganization does not qualify under § 354 by a conveyance of "substantially all" the assets and a liquidation of the transferor thereafter, it must qualify under § 355, or not at all. Section 356 is merely a "boot" section to tax the "extras" distributed that do not otherwise qualify under §§ 354 or 355.

²²¹ See INT. REV. CODE of 1954, § 355(a)(2)(C). This subsection is new in the 1954 Code. Under Int. Rev. Code of 1939, § 112(b)(11), a reorganization must be effected. The Senate Report accompanying the 1954 bill noted that now the formation of a holding company is not necessary to effect a distribution if a corporation already held stock in a subsidiary. This was necessary under the 1939 Code. See S. REP. NO. 1622, 83d Cong., 2d Sess. 267 (1954).

²²² INT. REV. CODE of 1954, § 355(a)(2)(A).

²²³ *Id.* § 355(a)(2)(B). Note the advantages here. Certain minority or dissenting shareholders may be discontinued in the old corporation via this method, yet retain equity interests in the corporate assets by the new shares in substantially the same value as before the exchange. Similarly, a closely-held corporation may be split into two corporations for the benefit of co-owners, each of whom may continue to operate his respective corporation independently of the other. This is apparently subchapter C's answer to subchapter K for the splitting of a corporate business in the same manner as a partnership.

²²⁴ The transferor does not necessarily have to dissolve pursuant to the laws of the state of incorporation, but it must rid itself of substantially all the assets.

shares in the corporation. The nondistributing transferor has as an asset the stock or securities of the transferee in place of its assets it has conveyed to the transferee. Since the transaction has the recognition of tax postponed at all levels, it seems tortuous to advance the theory that tax avoidance can occur.

A third limitation is contained in paragraph (3) of section 355(a) to the effect that the general rule will not apply if the principal amount of the securities received exceed the principal amount of the securities surrendered in connection with the distribution, or if securities are received and none are surrendered.²²⁵

Section 355 coverage begins where section 354 ends. Section 354 covers complete (or almost complete) distributions of the transferor; anything less than a substantial transfer must qualify under section 355.²²⁶ Both sections require the transferor corporation to distribute the stock received from the transferee to the shareholders.²²⁷

A fourth limitation is contained in section 355(b). There must be an active conduct of a trade or business on the part of the distributing corporation and the controlled corporation in which the stock is distributed. It is not necessary that the split-off or spun-off corporation be engaged in the same business—just the active conduct of a trade or business. Paragraph (2) under section 355(b) attempts to define even more conservatively what the restrictions on an active conduct of a trade or business should be. The trade or business must have been conducted for at least five years ending on the date of the distribution of the stock of the controlled corporation.²²⁸ Moreover, the control²²⁹ of the distributed corporation must not have been acquired within that five-year period by another corporation;²³⁰ but if it was, the transaction in which the control is acquired must not have been one in which gain or loss was recognized in whole or in part.²³¹

The Service initially took the position that one active business could not be split. Two or more active businesses in a corporation were required for a section 355 division. Then, in 1960, *Edmund P. Coady*²³² caused the obsolescence of a good many rulings that had denied division of one active business. In a well-reasoned opinion by Judge Tietjens the Regulation section 1.355-1(a) was

²²⁵ It is basic that the word "securities" in this context is in reference to debt instruments rather than equity participation, which is usually denominated "stocks."

²²⁶ See INT. REV. CODE of 1954, § 354(b)(1)(A), excepting (D) reorganizations involving less than a transfer of "substantially all" the assets.

²²⁷ Under a transaction qualifying under § 355, the transferor may retain a slight amount of the stock of the transferee, provided there is no plan to avoid taxes. INT. REV. CODE of 1954, § 355(a)(1)(D)(ii).

²²⁸ *Id.* § 355(b)(2)(B).

²²⁹ *Id.* § 355(a)(1)(D)(ii) also refers to the (D)'s control section, *id.* § 368(c).

²³⁰ *Id.* § 355(b)(2)(D)(i).

²³¹ *Id.* § 355(b)(2)(D)(ii). If the control was obtained in a § 351 transaction, clause (ii) is satisfied. No tax recognition occurs in that transaction, unless "other property or money" is acquired (§ 351(b)), or the liabilities-in-excess-of-basis section is involved (§ 357(c)).

²³² 33 T.C. 771 (1960), *aff'd by order in mem. decision*, 289 F.2d 490 (6th Cir. 1961). The Tax Court opinion is also an excellent review of the complete workings of § 355. For another overview of § 355, especially in connection with mergers, *inter alia*, see Morris, *Combining Divisive and Amalgamating Reorganizations—Section 355 Fails Again*, 46 TEXAS L. REV. 315 (1968). The article gives an in-depth analysis of *Curtis v. United States*, 336 F.2d 714 (6th Cir. 1964), and *Commissioner v. Morris Trust*, 367 F.2d 794 (4th Cir. 1966).

held invalid to the extent that it provided that a single business might not be divided.²³³ It is, therefore, rather well-settled that a single business may now become the subject matter of a divisive reorganization.

(b) *The Rulings.*

(1) *Old or New Trade or Business?* As previously mentioned, the business to be spun off²³⁴ must have been actively conducted for five years. A tricky exception is found in Revenue Ruling 56-227.²³⁵ This ruling involved a (D) reorganization in which the assets were transferred to a foreign corporation in a spin-off. The Service admitted that section 367²³⁶ was complied with, or at least not avoided. The new corporation was formed for valid business reasons. The transferor had been operating in the United States for the required time. Nevertheless, the Service said that this was a new venture, in a new territory, in a different country. The five-year rule was, therefore, not met because it constituted a "new" venture. The ruling placed some reliance on the now invalid Regulation section 1.355-1(a), but the disqualification seemed to be based on the five-year rule.

A subsequent ruling in the same year came to an almost irreconcilably different conclusion. Revenue Ruling 56-344²³⁷ involved a business in existence for five years which was being transferred to another state because of competition. A new corporation was formed to receive it in exchange for its shares. The Service viewed the transfer as a transfer of an already existing five-year business to a new location and not the formation of a new business. Therefore, section 355(b)(2) was met. But under Revenue Ruling 56-227 section 367 cannot be used as a basis for denial of qualification under section 355. Compared with Revenue Ruling 56-344 can it be said that there is a distinction between the transfer of "assets"²³⁸ and the transfer of a "business"?²³⁹ If so, the Service is tampering with logic and is exalting form over substance.

(2) *Rental Property.* The Service has traditionally frowned upon the spin-off of rental real estate to a controlled corporation, seldom finding an active business. Rental property is usually considered an investment asset, and, therefore, passively classified pursuant to the authority of Regulation section 1.355-1(c). Yet a little activity generated in the management of this property can change the Government's mind. For example, Revenue Ruling 56-355²⁴⁰ allowed a section 355 spin-off in a (D) reorganization of a building owned by a bank which occupied thirty-five percent of the space as a tenant and leased the

²³³ *Coady* has been followed in the Fifth Circuit. *United States v. W.W. Marett*, 325 F.2d 28 (5th Cir. 1963).

²³⁴ Or split-off or split-up. For purposes of this Article, whenever "spin-off" is mentioned, "split-off" and "split-up" should be understood to follow concurrently since the treatment is substantially the same.

²³⁵ 1956-1 CUM. BULL. 183.

²³⁶ INT. REV. CODE of 1954, § 367 requires that in the case of foreign corporations involving exchanges under certain Code sections that the Secretary or his delegate be convinced that the transaction was not in pursuance of a plan to avoid taxes principally. Oddly enough, *id.* § 368 is not one of the enumerated sections.

²³⁷ 1956-2 CUM. BULL. 195.

²³⁸ Assets were the subject matter of transfer in Rev. Rul. 56-227, 1956-1 CUM. BULL. 183.

²³⁹ The "business" was transferred in Rev. Rul. 56-344, 1956-2 CUM. BULL. 195. But does not a business essentially contain assets being put to use in a coordinated manner?

²⁴⁰ 1956-2 CUM. BULL. 210.

balance to other tenants. The bank also owned farm land and other rental properties. All were spun-off to a new corporation. The Service found nothing to prevent the properties from being active businesses of the bank.

Similarly, an eight-story building was the subject of a transfer in a (D) reorganization qualifying under section 355 in Revenue Ruling 58-164.²⁴¹ Sixty percent of the building had been leased to others five years before the transaction. Two years before the transaction one hundred percent was leased to outsiders. The ruling is silent as to whether any active management, maintenance, or other duties were required of the transferor. The Service deemed the rental business of the old corporation an active business under section 355(b)(1). Under section 355(a)(1) the receipt of all the stock in exchange for a portion of the shareholder's holdings (amounting to a non pro rata distribution) would not preclude the application of that section.

A different result was reached in Revenue Ruling 56-266.²⁴² A grocery chain produced and distributed bakery and creamery products. It also owned various parcels of real estate, but had no outside tenants. The chain even charged itself rentals for the real estate based on gross sales. In a (D) reorganization attempting to qualify under section 355 the chain organized three new corporations, transferring to them the bakery business, creamery business, and the real estate. The Service turned thumbs down on the real estate corporation, and taxed the distribution of that stock to the shareholders under section 301. Citing Regulation section 1.355-1(c) as authority the Service reasoned that "the ownership of a grocery chain did not represent the operation of a trade or business separate and apart from the grocery business."²⁴³ Fortunately, section 351 saved further taxation of the grocery chain and new corporation. The transfer did qualify for section 351 even though the shares distributed were taxed.

Investment assets may also be qualified under section 355 if they represent an insignificant or inconsequential portion of the assets transferred in relation to the total transferred. The Service took this position in Revenue Ruling 56-557²⁴⁴ wherein a bank, conducting an active real estate business, transferred that business to a new corporation along with certain investment assets. The investment assets had no relation to the real estate business and represented only a small portion of the total assets transferred. Because the amount transferred was insubstantial in comparison with the total "active" assets transferred section 355 was not rendered inapplicable.

Real estate, therefore, must be "active" in order to qualify as a distribution under section 355(b) in addition to satisfying the other rules of that section. If tax planning permits, and there is a view toward distribution at a later date, affirmative covenants and duties with respect to the operation, maintenance, and servicing of otherwise passive real estate assets should be incurred by the owners. This will lend an aura of activity to the business assets that may increase the probability of a favorable Service decision.

3. Section 351. Section 351 is analogous to the (D) reorganization in that it

²⁴¹ 1958-1 CUM. BULL. 184.

²⁴² 1956-1 CUM. BULL. 184.

²⁴³ *Id.* at 185.

²⁴⁴ 1956-2 CUM. BULL. 199.

involves a transfer to a corporation controlled by the transferor. Unlike the (D), the transferor may be plural, and consist of a partnership, individuals, a corporation, or any combination. There is no requirement under section 351 for a distribution of whatever is received in the transfer. Moreover, if there is a distribution, section 301 will probably apply.²⁴⁵

Section 351 also looks to the same control subsection, section 368(c). Indeed, section 351 and the (D) reorganization are literally indistinguishable during the initial phase involving the (D) transfer, since the requirements of section 351 are also met. But if the (D) reorganization is qualified under section 355, is section 351 necessarily inapplicable? Bear in mind that section 355 does not require a reorganization for qualification under it.

What appeared to be a (D) reorganization qualifying under section 355 was also held to be a section 351 transaction in Revenue Ruling 62-138.²⁴⁶ A banking corporation owned all the outstanding stock of a realty corporation, which in turn owned and operated several rental businesses. Two of the rental businesses were transferred to a new corporation, which became a wholly owned subsidiary of the realty corporation. The stock of the new subsidiary was transferred to the realty corporation, which transferred it to the banking corporation. The Service treated this as a section 351 transaction with a qualifying distribution under section 355. Since the transaction involved corporations, and an integrated plan was present, it is difficult to see how the transaction could escape classification as a (D) transaction qualifying under section 355. The successive distributions (from the realty corporation to its parent) would not constitute a stumbling block since section 355 qualifies these, not subparagraph (D).

If Revenue Ruling 62-138 seems inconsistent, then Revenue Ruling 58-218²⁴⁷ is also consistently inconsistent. What appeared to be a section 351 transaction was denominated a (D) reorganization. An association of insurance underwriters, having escrowed cash and other assets in a guaranty fund in accordance with state laws, desired to form a stock insurance company via the corporate route. The assets, less the cash drawn down, were distributed to the underwriters upon incorporation. It is perhaps pertinent to reveal that the association was previously taxed as a corporation. Nevertheless, the Service (1) treated the transaction as a reorganization within the meaning of section 368-(a)(1),²⁴⁸ (2) taxed the receipt of their original cash as a dividend under section 356(a)(2) to the extent of a ratable share of earnings and profits,²⁴⁹ and (3) allowed the earnings and profits of the association not affected by the distribution to become the earnings and profits of the new corporation under

²⁴⁵ See note 247 *infra*, and accompanying text.

²⁴⁶ 1962-2 CUM. BULL. 95.

²⁴⁷ 1958-1 CUM. BULL. 185.

²⁴⁸ The writer of the ruling did not complete the balance of the Code section so as to advise the reader under which subsection the reorganization fell. Obviously, if it was a transfer of assets in exchange for stock, it must be a (D).

²⁴⁹ To the extent the cash exceeded each recipient's ratable share of earnings and profits of the unincorporated association, the additional portion was taxed as a gain from the exchange of property. Naturally the basis of the stock received was increased under § 358(a) by the dividend and gain recognized.

The writer has heretofore vocalized his position on the taxing of the return of capital called "gain" in excess of the ratable share of earnings and profits. Here the cash returned

section 381.²⁵⁰ The ruling gives no clue as to why the reorganization sections were chosen for the caption of the transaction over section 351. Clearly section 351 is the proper vehicle through which an unincorporated association may incorporate. Yet subsection (D) was utilized. Since the distribution of the cash was given dividend treatment, section 301 could have worked in conjunction with section 351 as easily as sections 368 and 356.

Section 351 can give relief where subsection (D) cannot. As mentioned, an incomplete (D) reorganization is in essence a section 351 transaction; it is the subsequent distribution that finds either safe harbor or taxation in other sections of the Code. Some of the pre-*Coady*²⁵¹ rulings would not qualify a transaction under section 355 on the theory that there was really an attempt to divide a single business.²⁵² If section 355 could not be satisfied, there could be no (D) reorganization. But there can still be a section 351 transaction, and no subsequent qualification is needed. The transfers at least will be tax free, even if the distributions are not.

4. *Section 381.* Any reorganization will necessarily involve an interrelationship with corporate tax provisions. Section 381 of the Code in certain instances allows the carryover of the items listed in its subsection (c)²⁵³ to the acquiring corporation from the transferor corporation. The (D) reorganization receives its honorable mention in section 381(a)(2), but the attributes are available for carryovers *only* if the (D) reorganization qualifies under section 354(b)-(1)(A) or (B).²⁵⁴ A section 355 qualification will simply not suffice. One corporation accomplished a split-up under section 355(a) and attempted to use a net operating loss carryover from a prior year in the two new corporations. The Service denied the treatment by pointing to the definition in section 381(a)(2).²⁵⁵ Moreover, the legislative history indicated that section 381 was not meant to apply to divisive reorganizations.²⁵⁶

It is well to note for purposes of tax planning that (D) reorganizations qualifying under section 354(a)(1)(A) or (B) will automatically pass the earnings and profits of the transferor to the acquiring corporation.²⁵⁷

5. *Section 356.* Section 356 is the "boot" provision for the (D) reorganization and covers the extras received in a reorganization that sections 354 and 355 do not cover by definition. It was principally designed to cover dividends incident to a reorganization.²⁵⁸ Yet it also comes in to tag the hapless shareholder

was clearly earmarked as a deposit in a guaranty fund. How could it conceivably represent a ratable share of earnings and profits, especially in an unincorporated association (albeit taxed as a corporation for federal tax purposes)?

²⁵⁰ The net effect of the carryover of earnings and profits is treated in section V(7) *infra*.

²⁵¹ See note 232 *supra*.

²⁵² See notes 232-35 *supra*, and accompanying text.

²⁵³ Twenty-three paragraphs of corporate tax attributes are listed in § 381(c), each imposing its own limitations and qualifications for carryover.

²⁵⁴ This paragraph also states that the transaction must also qualify under § 361. But it seems redundant to acknowledge that a transaction is admittedly a (D), and also require that it meet § 361 requirements. Section 361 presupposes the existence of a valid reorganization.

²⁵⁵ Rev. Rul. 56-373, 1956-2 CUM. BULL. 217.

²⁵⁶ See REPORT OF THE SENATE COMM. ON FINANCE ON H.R. 8300, S. REP. NO. 1622, 83d Cong., 2d Sess. 52 (1954).

²⁵⁷ See the holding in paragraph (6) of Rev. Rul. 58-218, 1958-1 CUM. BULL. 185.

²⁵⁸ Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966).

caught in a liquidation-reincorporation or in a sale to a commonly owned corporation.

The recent Revenue Ruling 70-240²⁵⁹ involved a sale of one corporation's operating assets to another. One shareholder owned the stock of both corporations. The balance of the assets, mostly liquid, were distributed pursuant to section 331 after the debts were paid. Even though the fair market value price was paid for the assets, the Service claimed a (D) reorganization had taken place instead of a sale. In such a situation the shareholder would be treated as if he had received stock in the other corporation,²⁶⁰ and would be taxed on the liquidating distribution under section 356(a)(2) as a dividend rather than at capital gain rates under section 331.

The moral of this ruling is apparently that the concession of arm's length dealing between two commonly owned corporations will not override the application of liquidation-reincorporation and subsequent section 356 dividend treatment. What could the owner of both corporations have done to avoid this result and still achieve the liquidation of one into the other? The answer may be an oversimplification: transfer *all* assets, leaving none to go to the shareholder for section 356 treatment. There is admittedly no tax, but the owner still has the assets in corporate solution.

Section 356(a)(2) contains a built-in limitation on the amount of tax in a distribution. The dividend to a distributee would be recognized only to the extent "as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913."²⁶¹ The issue may be raised as to just which corporation is regarded as the distributing corporation—the transferor or transferee? The transferor corporation usually makes the distribution or liquidating dividend, and should be the logical candidate to examine for earnings and profits. If the distribution is clear-cut, the transferor's earnings and profits are deemed to be the amount from which the dividend is determined.²⁶² A contrary result was reached in *Davant*.²⁶³ The court could not ascertain with any degree of precision from which corporation the distribution came. Therefore, the undistributed earnings and profits of both corporations served as a basis from which dividends were calculated.

The balance of section 356(a)(2) advises that the excess distribution over and above the taxpayer's ratable share of earnings and profits is to be treated "as gain from the exchange of property."

One approach clearly not available to a petitioner in the Tax Court is that of showing the absence of the issuance of stock in connection with the transfer. The courts seemingly regard the issuance of additional stock as a "meaningless gesture"²⁶⁴ and do not interpret the statutes as requiring such a vain act.

6. *Section 1551*. Section 1551 will deny multiple surtax exemptions and the accumulated earnings credit in the proper circumstances. It will apply to trans-

²⁵⁹ 1970 INT. REV. BULL. NO. 20, at 17.

²⁶⁰ *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir.), *cert. denied*, 368 U.S. 836 (1961).

²⁶¹ INT. REV. CODE OF 1954, § 356(a)(2).

²⁶² *James Armour, Inc.*, 43 T.C. 295 (1964).

²⁶³ See note 203 *supra*, and accompanying text.

²⁶⁴ *James Armour, Inc.*, 43 T.C. 295, 307 (1964). See also *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir.), *rev'g* 33 T.C. 30, *cert. denied*, 368 U.S. 836 (1961).

fers of property to other corporations, such as those that occur in a (D) reorganization. It is clearly no consolation to be able to show a qualified (D) reorganization and the concomitant transfer pursuant to a valid business purpose, because section 1551 may still be involved if the Commissioner (or the court) believes that the acquisition of the additional surtax exemption of accumulated earnings credit was a "major purpose" of the transfer.²⁶⁵

One of the examples in the Regulations indicates that a new corporation receiving property from another corporation, both corporations having common owners, will fall within the proscription of the statute.²⁶⁶ Nevertheless, the axe does not fall automatically. Case law smiles favorably on the taxpayer if he can show that transfers in a (D) reorganization were not made with a major purpose of securing surtax exemptions.²⁶⁷

7. Section 312.

(a) *Generally.* Section 312 details all transactions that affect earnings and profits. Fortunately section 312(i) allows an allocation of the earnings and profits to the transferee corporation.²⁶⁸ Subsection (i) requires that the (D) must qualify under section 355.²⁶⁹ A (D) reorganization qualifying under section 354 presumably is not eligible for section 312(i) allocation of earnings and profits.²⁷⁰

The Regulations define how the allocation is to be made.²⁷¹ If the transfer is to a newly created corporation, the allocation of the earnings and profits shall be made in proportion to the fair market value of the business or businesses retained by the transferor and the business or businesses of the transferee.²⁷²

²⁶⁵ Treas. Reg. § 1.1551-1(h) (1954). The Regulations suggest that this burden may be met by the taxpayer's showing that the obtaining of the exemption or credit was not a major factor in relationship to the other matters which prompted the transfer.

²⁶⁶ Treas. Reg. § 1.551-1(g) (4), example (1) (1954).

²⁶⁷ In *Cronstroms Mfg. Inc.*, 36 T.C. 500 (1961), two new corporations were formed for the purpose of receiving the assets of a common parent corporation. The two petitioner corporations did their evidence homework well in view of the court's language, *id.* at 506: "[T]he transfers to the petitioners were not made with a major purpose of securing surtax exemptions. Petitioners have satisfied us that there were a host of purposes for these transfers. . . . Not one of these purposes has the remotest connection with securing the surtax exemption"

²⁶⁸ The reason it is fortunate is because there are few circumstances wherein earnings and profits leave a corporation without tax. Moreover, the accumulated earnings tax is that much further away. *But see* notes 276-79 *infra*, and accompanying text.

²⁶⁹ Or, as the Code reads, "so much of section 356 as relates to section 355." INT. REV. CODE of 1954, § 312(i).

²⁷⁰ Why not? If there is an allocation of the proportionate amounts of the earnings and profits on the basis of the proportion of assets transferred to those retained, then why not have the same allocation apply? *See* the discussion in section II(D) *supra*.

To ask is to answer it. The § 354(b) qualification for the (D) is that "substantially all" the assets must be transferred. The amount of assets retained by the transferor upon which the proportionate amount of earnings and profits would be calculated would be de minimis. Moreover, Treas. Reg. § 1.312-11, T.D. 6476, 1960-1 CUM. BULL. 114 apparently controls so as to pass the earnings and profits through to the transferee.

²⁷¹ Treas. Reg. § 1.312-10 (1954), entitled "Allocation of earnings in certain corporate separations." Subsection (a) only is applicable.

²⁷² The aforecited Regulation also adds "and interests in any other properties." From a nonpragmatic viewpoint, the Regulations seem to operate under the delusion that a newly created corporation will somehow have several businesses and "other properties" from some source other than the transferor. The newly created corporation is generally what it is thought to be and no more: a receptacle for the transfer of the assets so that the stock or securities representing these assets can be put to better use in the hands of the transferor and its shareholders.

The Regulations go further to state that the allocation should be made "in a proper case"²⁷³ between the transferor and transferee in proportion to the net basis²⁷⁴ of the assets transferred and of the assets retained. The transferee corporation must also include the allocated earnings and profits of the transferor in its computation of earnings and profits for the first taxable year ending after the date of the transaction.²⁷⁵

If there is merely a distribution or exchange to which section 355 alone applies, without a qualifying (D) reorganization, then subsection (b) of Regulation section 1.312-10 applies. In such an instance the lesser of the net worth of the controlled corporation, or the amount by which earnings and profits would have been decreased if there had been a (D) reorganization, will be applicable to the distributing corporation.

The interplay of subparagraph (D) and section 312 is illustrated by the recent case of *Bennet v. United States*.²⁷⁶ The taxpayers had received a distribution of stock and subsequent dividends in a (D) spin-off. Because they allocated earnings and profits according to the proportionate net tax bases of the two corporations after the reorganization, the taxpayers contended that a portion of the dividend was a return of capital. Since the assets spun off had a higher fair market value than tax basis, the Government naturally contended that the allocation should be based on the values after the spin-off. The trial commissioner announced that the objective of section 312 was to incorporate the rule in *Commissioner v. Sansome*²⁷⁷ to the effect that whatever were "earnings and profits" of the original company remain, for purposes of a distribution, "earnings and profits" of the successor. The trial commissioner further reasoned that the application of this rule would dictate that no transferee could be allocated profits and earnings in excess of its net worth, a conclusion which would effectively neutralize the (D) reorganization with respect to future shareholder taxability.

The Court of Claims declined to pass on the "net worth" limitation, but reached an identical result by reference to Regulation section 1.312-10(a).²⁷⁸ The Regulation does follow *Sansome* in principle, but allows some leeway for the (D) reorganization: (1) for newly created corporations, to which earnings and profits are allocated in proportion to the fair market value of the business; and (2) in a "proper case" allocation is made on the net basis of assets retained and those transferred. The Court of Claims noted that under the Regulation the fair market value method is *prima facie* proper. In this instance the taxpayer failed to show that this was a "proper case" for application of the net basis method. This ruling keeps alive the well-established interpretation based

²⁷³ Treas. Reg. § 1.312-10(a) (1954). How does "in a proper case" differ from "in the case of a newly created corporation?" In the latter instance, allocation is made on the basis of the businesses; in the former on the basis of net assets. Since a business has some direct correlation in size with its underlying assets, the distinction may be in words only.

²⁷⁴ Treas. Reg. § 1.312-10(a) (1954). This Regulation defines "net basis" as the basis of the assets less liabilities assumed, or liabilities to which assets are subject.

²⁷⁵ Treas. Reg. § 1.312-10 (1954).

²⁷⁶ 192 Ct. Cl. 448, 427 F.2d 1202 (1970).

²⁷⁷ 60 F.2d 1931 (2d Cir.), *cert. denied*, 287 U.S. 667 (1932).

²⁷⁸ 427 F.2d at 1213.

on *Sansome* that section 312 is a proscription on the escape of shareholder taxation on earnings and profits distributed after a divisive reorganization.²⁷⁹

(b) *Deficits*. Subsection (c) of Regulation section 1.312-10 states that a deficit of a distributing corporation within the meaning of section 355 may not be allocated to a controlled corporation. In the instance of a spin-off or split-off the transferor corporation must retain the deficit, no part of which may inure to the transferee. But if there is a split-up, there is no transferor corporation in existence. The deficit is lost.²⁸⁰ It is, therefore, advisable not to effect a (D) reorganization split-up if the transferor has a deficit.

(c) *Section 354 Qualification*. Regulation section 1.312-11 deals with the effect on earnings and profits of a (D) reorganization qualifying under section 354. Regulation section 1.312-10 deals only with corporate separations.²⁸¹ Regulation section 1.312-11 refers to section 381 for carryover effects of earnings and profits and deficits thereto. Section 381(c)(2)(A) advises that the earnings and profits (or the deficit) shall be deemed to have been received by the transferee on the closing date of the transfer. Section 381(c)(2)(B) places a limit on the usage of the deficit by the transferee. It may only be used to offset the earnings and profits of the transferee that are accumulated after the date of the transfer. The accounting treatment given these deficits in earnings and profits is set forth in great detail in the Regulations.²⁸²

8. *Section 306*. It is basic that a dividend of redeemable preferred stock falls within section 306 and is accordingly entitled to ordinary income treatment only by the recipient. It is very possible to receive section 306 stock in connection with a (D) reorganization. Revenue Ruling 59-197²⁸³ shows how this is accomplished.

A (D) reorganization took place in connection with a section 355 split-off. The shareholder in question surrendered all his stock in the old corporation for common and preferred stock in the new one. The preferred was redeemable. The par value and redemption price of the preferred received by the shareholder was such that it was in proportion to his allocable share of earnings and profits immediately held before the distribution and exchange. Under Regulation section 1.306-3(d) the preferred would be section 306 stock if he had received cash instead. This, of course, would be a dividend.

9. *Basis*. To digress briefly, it has been seen that two Code sections control the nonrecognition of the assets and stock exchanged in the (D) reorganization. Section 354 protects the shareholders from recognition of tax, and section 361 protects the corporation. The tax rationale in an instance of nonrecognition is to leave everything as it was beforehand, even the basis. If tax is to be deferred

²⁷⁹ See, e.g., *Commissioner v. Phipps*, 336 U.S. 410 (1949); *Commissioner v. Munter*, 331 U.S. 210 (1947).

²⁸⁰ Nesson, *Earnings and Profits Discontinuities Under the 1954 Code*, 77 HARV. L. REV. 450, 489 (1964). See also Lyons, *Some Problems in Corporate Separations Under the 1954 Code*, 12 TAX L. REV. 15, 23 (1957).

²⁸¹ The Regulations for some reason wish to draw a distinction in nomenclature between a corporate separation and a corporate reorganization. Nevertheless, a (D) is a (D) whether it qualifies under § 355 or § 354.

²⁸² Treas. Reg. § 1.381(c)(2)-1, T.D. 6692, 1963-2 CUM. BULL. 150.

²⁸³ 1959-1 CUM. BULL. 77.

until a subsequent event, then no party increases or decreases his starting point, or basis, in the transaction.

(a) *To the Shareholder.* As mentioned, the (D) reorganization must qualify under sections 354, 355, or 356—the shareholder-distributee's special Code sections. For basis, section 358 applies, *inter alia*, to exchanges to which sections 354, 355, or 356 apply. By a circuitous path section 358 arrives at the shareholder's doorstep in a (D) reorganization.

The basic rule of section 358 is that the shareholder will attach to the property received the same basis as that of the property surrendered—provided no gain or loss is recognized on the exchange.²⁸⁴ If anything else is distributed, subparagraphs (A) and (B) of section 358(a)(1) become applicable to the basis. Subparagraph (A) decreases the basis in three instances: (1) by the fair market value of any property received, (2) by the amount of money received, and (3) by the amount of loss sustained by the shareholder on the exchange. Conversely, subparagraph (B) may increase basis by: (1) the amount of dividend received, and (2) the amount of gain other than from a dividend.

Subparagraph (2) under the general rule of section 358(a) states that any other property received shall have as its basis the fair market value at the time of its receipt. This tax effect is paraphrased in section 358(a)(1)(A)(i), in that the overall basis of the shareholder will be reduced by the receipt of this type of property.

Subsection (b) tells the shareholder how to allocate his basis. Initially he is to allocate basis among all assets received without recognition of gain or loss. If the shareholder receives several classes of stock and concurrently surrenders several classes, whatever his combination, he is required by the Regulations to allocate basis in proportion to the respective fair market values.²⁸⁵ If he participates in a section 355 distribution without surrendering any stock, basis must then be allocated among all his properties, which means an allocation among retained stock and that received.

Subsection (d) treats the assumption of a liability of the corporation as money received by the corporation on the exchange.²⁸⁶ The Regulations reveal that this situation arises most frequently in section 351 transfers in which a taxpayer transfers encumbered property to a corporation and not in a corporate reorganization.²⁸⁷

It is permissible for the shareholder to average the basis to the stock and securities received by the substitution required by section 358.²⁸⁸ But if recognizable gain or loss enters the picture, the problem changes. The shareholder must compute separate gain or loss on the shares going out, *i.e.*, exchanged. The dilemma he faces is that the gain may not be offset by the loss, even if he owns

²⁸⁴ Recall at this point that the prime if not only function of § 356 is to tax the gain recognized on an exchange, a function that §§ 354 and 355 were not designed to accomplish.

²⁸⁵ Treas. Reg. § 1.356-2(a) (1954). Mathematical computations are given under paragraph (b) of this Regulation to fit nearly any occasion.

²⁸⁶ The subsection in reference speaks literally of the "taxpayer," not the corporation. It would not make much sense to equate the taxpayer with the shareholder for the interpretation here, since the shareholder would rarely have a liability or debt assumed by the transferee corporation. It is his corporation, the transferor, that is transferring the property (assets) to the transferee. And only the transferee can assume the liability.

²⁸⁷ Treas. Reg. § 1.358-3 (1954).

²⁸⁸ See B. BITTKER & J. EUSTICE, *supra* note 70, § 12.34.

two blocks of the stock of the same corporation purchased at separate intervals.²⁸⁹ The source of this unjust bit of law is, as so many other parts of taxation, not grounded in logic but in application of another Code section. The boot section, section 356(c), unequivocally states that no gain or loss shall be recognized from the exchange or distribution to which sections 354 or 355 apply. The interpretation has been that the Commissioner can eat the fruit while the taxpayer spits out the seed.²⁹⁰

(b) *To the Transferor.* Section 358 is also the Code basis section for the corporate transferor. At first it may seem that section 362 is the applicable basis section because of its heading "Basis to Corporations." It is excluded from the (D) reorganization because subsection (a) relates only to section 351 transfers or for paid-in surplus or contributions to capital. Subsection (b) is explicitly inapplicable if the property acquired in the transfer consists of stock or securities,²⁹¹ which is just what the transferor gets for his asset transfer. Under section 358 the transferor will take as its basis for the stock or securities received the basis of the assets transferred. The rules outlined for the shareholders apply to the transferor corporation, except for the greater emphasis necessary on the assumption of liability under section 358(d).

Under section 358(d) the transferor is required to reduce his basis in the stock or securities received by the amount of liabilities assumed by the transferee on the assets transferred to the latter. There is one limitation. The transferor cannot reduce basis below zero in the stock or securities received because of the assumption of liabilities. Negative bases do not presently exist in the tax law, although serious discussion is afoot that questions the logic of that exclusion.²⁹²

If the total liabilities assumed plus the total liabilities to which the properties are subject exceed the adjusted basis of the transferor, gain will be recognized by the transferor in the amount of the excess by application of section 357(c). Subparagraph (B) of section 357(c)(1) is pointed directly at the (D) reorganization, calling it by name. Paragraph (2) goes on to say that paragraph (1) will not apply in instances in which the principal purpose is the avoidance of federal income tax on the exchange, or no bona fide business purpose is present.²⁹³ In either of these instances the tax liability is on the total liability assumed or taken subject to by the transferee rather than the excess liability assumed.²⁹⁴ The difference is material if the taxpayer cannot sustain the burden of proof.²⁹⁵

It is difficult to reconcile full taxation on the liabilities transferred under

²⁸⁹ See the result to the taxpayer in Rev. Rul. 68-23, 1968-1 CUM. BULL. 144.

²⁹⁰ See *Curtis v. United States*, 336 F.2d 714 (6th Cir. 1964), taxing the gain but denying any offsetting loss from the same transaction.

²⁹¹ The subsection goes on to say that if a (B) reorganization is in the making, it will apply, and basis of the property acquired is the same as that of the transferor.

²⁹² See the court's extended treatment in *Easson v. Commissioner*, 294 F.2d 653 (9th Cir. 1961).

²⁹³ INT. REV. CODE of 1954, § 357(b)(1)(A), (B). As a practical matter it is almost redundant for the Code to state that a bona fide business purpose must be present in light of the infusion into all walks of tax life of the *Gregory* doctrine.

²⁹⁴ INT. REV. CODE of 1954, § 357(b)(1)(B).

²⁹⁵ The taxpayer has the "clear preponderance" burden of proof. INT. REV. CODE of 1954, § 357(b)(2).

section 357(c)(2) with the theme of reorganizations in general. Section 368 in essence defines the reorganizations that escape taxation. If there is compliance with section 368, there is a reorganization which is not a change in substance to the extent that it should be taxed. If this result is sound, why should there be a tax because of section 357(c)(2)? Qualification under section 368 indicates that there is no event for taxation on the exchange. A better rule would call for either no taxation or full taxation. Qualification of a reorganization under any subparagraph of section 368(a)(1) should necessarily be dispositive of the tax consequences of that transaction, rather than the result being contingent upon qualification under several other Code sections that may or may not be related to the exchange.²⁹⁶

VI. CONCLUSION

One of the gratifying rewards of tax planning lies in the manipulation of Code requirements to effectuate a given purpose. On its surface the field of corporate reorganization posits an opportunity for such a task. Fulfillment of the steps necessary for qualification should seemingly grant the end result sought. But all too often this does not occur. How can assurance in the reorganization sought be achieved with some predictability of the outcome?

The answer, of course, is the same as that suggested by most law commentators. There is a need, it is said in nearly all controversial fields of law, for clarification by further legislation to eliminate the confusion and irreconcilability of the court decisions. Yet as soon as the legislation is suggested, passed, and implemented, problems of interpretation arise all over again and some persevering taxpayer must again pioneer another legal doctrine and immortalize himself by titling a court decision for posterity.²⁹⁷

But if court decisions cannot unravel the ambiguities, legislation must be the only answer. The definitional field is a good place to begin. Take control as an example. This is defined in section 368(c) with a fair amount of mathematical exactness, if that solves anything. Yet our case law interpretation of control after the (D) reorganization concerns itself very little with the arithmetic. Just how long the taxpayer held it and what were his subjective intentions appear to be the principle issues in a section 368(c) determination. But a literal reading of the Code and Regulations would not even reveal that this was a problem.

The holding period for control could be simplified by picking an arbitrary time period for which it must be maintained. A period of four months would test the management of the new holders of the transferee's stock. Concrete commitments for disposal of control after this time period should be allowed. The law must concede a time period, the expiration of which allows a man to plan his affairs with some element of certainty.²⁹⁸

²⁹⁶ By reference to the table of contents of this Article one may obtain an idea of the number of other Code sections involved in reorganizations.

²⁹⁷ Mrs. Gregory is known to all tax enthusiasts from *Gregory v. Helvering*, 293 U.S. 465 (1935).

²⁹⁸ Analogous, of course, is the doctrine of the Statute of Limitations. Beyond this varying period (from state to state) a litigant can have some assurance that he cannot be sued, and vice versa.

The definition of "substantially all" in the section 354(b)(1)(A) qualification section for the (D) reorganization has been troublesome. Interpretation has centered on what constitutes essential or operating assets. Why not adopt a percentage of gross or net assets, as the Service has attempted to do by rulings? A Code sanction would remove these doubts.

The involuntary (D) reorganization, the liquidation-reincorporation, certainly poses a frightening nightmare to an unsuspecting taxpayer. Any later disposition of liquidated assets will be subject to the attack if a corporate vehicle is employed. But certainty could be gained by legislating a period of at least six months as a time period in which the assets received may not be utilized in further corporate solution, under penalty of invoking the reincorporation doctrine. Moreover, the ultimate benefit to be gained by reincorporation would be largely denied the taxpayer if such were his intentions, since restraint from future operations in corporate form would negate the utility of the operating assets. The loss of the essential assets for any ongoing business for such a time period would cause material deleterious effects on that business. The counterbalancing advantage to the taxpayer is that he knows with certainty what he may do after the expiration of the time period.²⁹⁹

Space does not permit a tirade into the faults of section 355. The section may stand on its own, and is not absolutely necessary for (D) qualification since section 354 is still available. Section 355 has been thoroughly documented by worthwhile criticism that should produce constructive revision at the next legislative opportunity.³⁰⁰

The interrelationship of section 351 and the (D) reorganization could stand further definition. It is not enough to remark that a partially completed (D) reorganization is in reality a section 351 transaction without the distribution. Section 351 could be positioned in the reorganization definitions as another form of corporate reorganization. It may well be that now, but it is not so labeled. If it were given the subparagraph designation that (A) through (F) now enjoy, one result would be to destroy the mandatory distribution requirement of sections 354 and 355. Even now, of course, no distribution is required under section 351.

The trend of the (D) reorganization is far from clear. There appears to be no movement toward liberal interpretation of its usage. By the same token, disqualification is not automatic if the courts and the Service are convinced of the innocuousness of the transaction. As an afterthought, or maybe a wish, perhaps another Supreme Court interpretation of subparagraph (D) will eliminate some of the present inconsistencies.³⁰¹

²⁹⁹ And conversely, he knows for sure what he *cannot* do with the liquidated assets during the proscribed time period.

³⁰⁰ See, e.g., Morris, *Combining Divisive and Amalgamating Reorganizations—Section 355 Fails Again*, 46 TEXAS L. REV. 315 (1968).

³⁰¹ When the word "another" is used, reference is implicitly made to the first rather famous (D) reorganization, *Gregory v. Helvering*, 293 U.S. 465 (1935), which did not embark on a substantive interpretation of the (D) mechanics.